Whoppers and a Side of Fries:
Can Regulators Eat All on Their Plate?

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It's a pleasure today to follow so many distinguished speakers on the important rules aimed at reforming global finance. Immediately before my remarks, you've heard in-depth presentations on the Basel III liquidity and capital rules, as well as on the pending surcharge for behemoth banks. I'll add one more rule to this pile – the living-will and resolution standards – and then assess what the sum total of all these mammoth rules means for the future of finance and the hoped-for recovery.

First, I'll point to the contradictions inherent in doing so many ambitious rules at the same time with no real understanding of what each will do in its own right, let alone in concert with all the others. I fear that, in their understandable effort to right all that went wrong, regulators have added every topping on their menu to the basic burger and, for good measure, piled every condiment they can find atop the whopper even while trying to eat a side of fries and slurp down a jumbo shake. Each ingredient on its own might be fine, but taken together all at the same time, they'll make you sick.

Last Thursday, FRB Governor Dan Tarullo argued for this all-you-can-eat policy. Indeed, he added a few items to the menu, mobilizing industrial-organization theory. But, in a galaxy far, far away, I wrote a doctoral dissertation on another construct – organization theory. An axiom of this one is that incremental decisions – one by one best guesses based on as much evidence as one can find – is better than grand plans, called "synoptic" decisions in this field of work. The defense of incrementalism – my school, as you can tell – is that one makes fewer mistakes and sinks less cost into immutable, irreversible grand schemes.

But, assume for the moment that regulators' stomachs are as big as their eyes and they can in fact down all on their plates. This brings me to my next topic: the adverse impact of the uncertainties spawned by all of these incomplete rules set for inconsistent implementation. In our practice, we see private capital ready and willing to go into the financial sector stymied by the inability to anticipate the regulatory landscape. I can't think of a strategic decision in this sector that isn't now driven first and foremost by regulatory policy considerations. The longer we don't know who's really doing what to whom, the longer private capital will sit it out and, then, the harder and longer the recovery.

Thus, the plea to which I'll return at the close of my remarks: regulators should step away from the awesome constructs of complex rules based on untested premises that litters the Basel and FSB agendas. Finalize a few key criteria that can be applied across the financial industry – not just to banks, make these the ones that are transparent measurable and enforceable and, then, give regulators and the industry some time to get something right before acting on the next big fix. If Basel and global regulators can't work in this manner, then the U.S. should cut its losses and do it alone.

Will this mean that some wrongs remain unrighted and, thus, that some risks remain unreformed? Of course, but an incremental agenda like this avoids the latest systemic risk: regulators piling so much on their plates that the resulting meal is little more than an inconclusive mess.

What Rules Are For

Let me hasten to say that I'm not opposed to the rewrite of financial-industry regulation. Indeed, I think a predicate is that reform should go farther than now contemplated and encompass not just big banks, but also the panoply of financial firms now more than content in the shadows. The key question isn't whether there needs to be better rules; rather, it's what goal the rules aim at so we know which to emphasize and enforce when and how. When one tries, as regulators now do, to solve all of the many regulatory failures that preceded the crisis all at once, not much gets done and what's done doesn't fit well with what's to come.

Let's step back and ask a fundamental question: what's the real big problem that created the financial crisis? In my view, it's too big to fail or TBTF. Regulators can build the Tower of Babel of Basel rules as high as they want but someone will find a way around or under it if TBTF is the tantamount axiom of global finance. Conversely, fix TBTF for real and for now and the market will quickly learn to take care of itself. We'll still need rules, as well as emergency backstops like the Federal Reserve's discount window and deposit insurance, but these rules are time-tested and limited to necessary market safeguards that stop well short – or should – of TBTF.

Because regulators are, in at least some of their rules, resigned to TBTF, they have crafted much of the new regime, especially all its surcharges on "negative externalities" derived from TBTF. What are negative externalities? They are economist talk for the cost to society of allowing banks to balloon in size and risk without any negative impact on their creditors, shareholders or management. As an array of post-crisis papers and speeches have rightly argued, TBTF financial institutions play with the taxpayer's cards, not their own.

But, is this problem solved by new capital rules or the liquidity standards, even if a surcharge is put atop them? As even whopper advocates acknowledge, the answer is no. There are good reasons to reform the capital and liquidity rules – reasons often more than evident in the decades it took Basel to bring itself back to the table to rewrite Basel I. But these reasons are germane to the backstops banks need to perform their vital credit-intermediation role, not to the broader expectation of invulnerability.

If TBTF is fixed – and not just for banks – rules need not be crafted to strangle institutions before they fall into the public's arms. If SIFIs can't be rescued, they need not be taxed as if they will be.

Why Pickles Don't Go with a Shake

Now, to the real-world impact of all these rules. The tab is very, very high on regulated banks because regulators have bellyed up to the bar and ordered everything they see in hopes that one or another of the menu items will make things better. Instead of picking a few known targets that are critical to the top reform priority – TBTF – regulators are issuing hundreds and hundreds of pages of ever more complex requirements largely aimed only at banks. Regulators know systemic risk and TBTF lurk in other corners of the financial system, but unable even to agree on the most important reform for systemic banks, they can't come close to other financial institutions.

This has two obvious and dangerous consequences. First, it leaves known problems – think MMFs – as is so that critical facets of the 2008 crisis remained untouched to sow the seeds of the 2011 one. Second, it casts a pall over banks which are the fundamental engine of credit intermediation and, thus, economic recovery.

Conclusion

I simply don't know how to advise clients with private capital sitting on the sidelines. At board meetings, we do strategic analyses of pending rules that are often the most critical deciding factors for strategic decisions. I can say which rule would do what, but putting them all together for a strategic analysis is complicated, if not made impossible, by the uncertainties and inconsistencies in all of these strategic proposals.

Indeed, the situation is compounded by other rules I haven't even discussed. How, for example, can we advise a client wanting to get into U.S. residential finance when we don't know critical deciding points – not just the capital that applies to a firm, but also whether or not there will be risk retention, GSEs or even an FHA in the mortgage space? M&A? Forget it for now if a firm is of any size.

So, let me echo a plea we hear all the time from our clients. It's not the one for fewer rules that cost less – some of the rules in the works do make sense. It's the one for certainty and consistency. Tell a firm what its key regulatory criteria are, when they will apply and – most important to the firm – that the rules will also apply to domestic and global competition, and a company knows what to do. It might not be happy, but it can and will act. This – not a new plan for still more rules – brings capital out of the bunker and back into the economy – an urgently needed policy action to propel the recovery into real, high gear.