



The Monetary Realist

Lax Governance and Poor Supervision

BY ADAM S. POSEN

In the current atmosphere, one could be forgiven for thinking that the current financial meltdown was due to a technical engineering problem, or at least that the U.S. Treasury thinks so. The complex proposals Treasury recently put forward—for stress tests, bad asset pricing, and bank recapitalization without government control—seem consistent with this belief. They treat the financial crisis as a failure of specific mechanisms subject to a technical fix by the more clever engineers now in charge. If only the risk models used by investors and supervisors were less short-sighted, less blindly reliant on so-called Gaussian copulas; if only banks' private managers and public supervisors had the intellectual or computational firepower to see how various risks interacted; and thus, if only we can carefully realign incentives and information flows, we can fix the financial system.

Yet it was not technical failures, mistaken models, misaligned incentives, computational errors, or gaps in risk monitoring that led us to the financial wreckage we see today. These all happened, but they were symptoms, not causes. What led us to today's financial wreckage was a decade of lax governance and supervision of financial companies. And that permissive environment was itself the result of a politically powerful view in favor of self-regulation and expansion by banks and near-banks, driven by a combination of ideology and self-interest. In fact, the design of Basel II was an expression of the same impetus toward self-regulation:

its implementation depended upon trusting the banks' own models and trusting supervisors to decide whether or not risky activities like SIVs could be treated as off-balance-sheet. We should not be surprised, then, at how little Basel II did to prevent the crisis.

Indeed, more than almost anything, political environments determine the nature and effectiveness of financial regulation. This should be obvious. Economic institutions and policy frameworks are the result of political processes, not of *tabula rasa* designs or of independent market evolution. Accordingly, they reflect the dominance of particular interest groups and ideas at a given moment. Societies grant central banks independence when a politically dominant coalition decides that inflation fighting is a priority and creditor interests are paramount. They may do so for well-intended reasons, but the institutions reflect the political environment. The same holds for fiscal policy: balanced budget amendments and other fiscal rules are adopted when societies decide budgetary discipline is important. Those fiscal rules get ignored or dropped when politically dominant coalitions decide they do not care about balancing budgets, as we saw during the Bush years.

This is not to say financial incentives and design of regulation are irrelevant. Rather, they matter a great deal, but only once the proper political environment is in place. When the political environment leads to lax oversight of banks, however, regulations are not enforced. Supervision is run with the forbearance of (or even in

collusion with) the supervised—no matter what is on the books. The past decade illustrates exactly this. The message is not to ignore regulatory design, but to properly see its specifics as secondary, and to be humble about their likelihood of achieving a desired goal in the absence of larger political realignment supportive of those goals.

Yet the Obama economic team seems to be ignoring the importance of political commitment to stricter financial oversight, and in danger of becoming lost in theory-driven institutional design. In today's financial crisis, a political consensus to rein in financial excess is attainable. So is forcing a retreat of financial opportunists through the use of overwhelming force. But to achieve this, the Obama administration must stop looking



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for technical tactics and get on with building the political coalition for victory. That is why I fear that the administration's current attempts to put carefully designed incentives in place (by gaming out specific mechanisms they hope will entice private investors into buying troubled assets) are likely to fail to resolve the crisis. Worse, they waste time and political capital while financial instability persists. And they give the political impression both to self-interested financial firms and to the public at large that the prior bias towards promotion of financial institutions' interests is largely unaltered.

Of course, technical cleverness is not the sole impetus for the present attempts to jury-rig the financial bailout. These complicated proposals are likely motivated as well by some combination of the desire to avoid asking Congress for massive additional on-budget expenditures, the hope that private investment will raise the value of banks' assets before the stress tests are completed, the political concern that Obama's image as a moderate Democrat would be hurt if he nationalizes American banks, and the residual ideological hostility to public interference in the financial system. All but the last are valid concerns.

The result remains that all the complex proposed schemes for the financial clean-up—the public-private-not-so-bad-aggregator bank, the associated guarantees on illiquid asset values for private investors that just beg to be resold as derivatives, the complex attempts at government control of banks while avoiding actual majority ownership, the forward-looking carefully calibrated stress tests, and the attempts to create “price discovery” for distressed assets without actually marking them down to their current market discounted values—are just too clever by half, and miss the point. And like most over-thought approaches to navigating policy dilemmas while ducking political discussion and open redistribution, this bundle of programs will likely fail.

What is the alternative? Keep the bank clean-up simple and do it quickly. This will not only sacrifice little in terms of effectiveness and cost—in fact, I would argue it would increase effectiveness and lower long-term costs. It will

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also bring policy into visible consistency with President Obama's rhetoric about a new approach to financial responsibility. A simpler, speedier program would:

- Mark to market, or price bad assets conservatively close to zero, and then bolster bank balance sheets for those losses as necessary with the injection of more capital.
- Not wait around for getting the prices “right” with an arcane mechanism or set of tests.
- Resist the temptation to subsidize viable financial firms, even to get them to buy things.
- When taxpayers put lots of money into insolvent institutions, take voting and managerial control temporarily for the government as the taxpayers' agent.
- Cleanly put expenditures and purchases on budget, and make sales of government stakes and assets clean full sales—that is, no public-private partnerships.
- Set up a publicly controlled bad bank (or banks) on the Resolution Trust

Corporation model. In so doing, keep most of the upside on resale of currently distressed assets for the taxpayer, and restructure some assets.

- Push Congress to consolidate systemic regulation quickly, perhaps in the Federal Reserve, but in any event impose stricter oversight of the supervisors and allow less room for discretion.
- Listen to European proposals for additional financial regulation with a more open mind, and let them lead on some of those issues, so long as the transatlantic playing field is kept level.

Ultimately, what matters is convincing the general public, financial system stakeholders, and particularly the regulators and supervisors themselves that the environment has changed. Credible political commitment to financial rules that prioritize systemic stability over private independence will lead enforcement of those rules in ways that deliver stability. The initial design of specific rules do not matter near as much as the political will they convey. Their implementation will adapt in future to their political environment anyway.

All told, the direct costs from replacing some of these complex proposals with theoretically sub-optimal simple approaches are second-order—that is, small in practice. The costs of delay and of confused messages while in pursuit of the optimal technical fix, however, will be first-order, or very large. In any event, a technical fix alone will be insufficient, and will not be robust enough to withstand political and economic pressures to come. The administration's current financial bailout proposals duck building political consensus for real financial change in favor of trying to retain buy-in from the very financial incumbents who want to hold regulators hostage—which will discredit the effort in the long run. Better to keep it simple, smarties. ♦