

Chapter 5: Executive Summary

Enhanced Regulation of Large, Complex Financial Institutions

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Background

Deregulation in the 1990s gave rise to a new generation of what the Federal Reserve has called “large complex financial institutions” (LCFIs). These are huge private sector enterprises engaged in a broad array of financial services including commercial banking, investment banking, asset management and insurance. Banking regulators now generally regard them as too-big-to-fail (TBTF).

The expanding LCFI share of the US financial services market suggests that the beneficial effects of economies of scale and scope and related operating-efficiencies outweigh the costs of complexity, increased risk-exposure and conflicts of interest. But their record of massive credit write-offs, regulatory infractions, repeated legal settlements, and poor long-term share price performance suggests the opposite conclusion.

In today’s global financial crisis, all of the LCFIs bailed out by governments were rescued because the social cost of their failure was considered unacceptable. Whether it was Bear Stearns, FNMA, Citigroup or AIG, creditors who bet that these firms were too big to fail have won while taxpayers have lost. The implicit public subsidy was there all along, and will surely be there going forward. If it continues, this public subsidy will create perverse incentives and major distortions in financial market competition in favor of LCFIs—and against financial intermediaries who have to survive on their own. Unless a new regulatory approach to LCFIs is taken up while the current crisis has captured everyone’s attention, we may very well be back in yet another crisis only a few years down the road.

The Issues

Current discussions of regulatory reform center on redefining risk-adjusted capital adequacy for financial intermediaries, requiring greater transparency for financial products, establishing a solid infrastructure for derivatives trading, and otherwise improving the financial system’s robustness with as little damage as possible to its efficiency and creativity. The policy options for financial institutions include *regulation by function* (insurance, commercial banking, asset management and securities) or alternatively *regulation by type of institution* or charter (basically commercial banks, broker-dealers, managed funds and insurance companies), covering all of their businesses. We believe that for the vast majority of financial

firms—those that are not LCFIs—the first option, regulation by function, stands the best chance of success. It will develop the depth of expertise needed to understand highly specialized intermediation dynamics, and ensure that firms chartered to business in these key functions maintain high standards and conduct themselves appropriately.

A Different Approach to Regulating LCFIs

We believe that regulation by function is not enough in the case of LCFIs. For these institutions, we advocate a third option – a special *dedicated regulator for LCFIs*.

Why? Because LCFIs are both different in character from functional specialists and pose a much more insidious threat to the global financial system. Our proposed special LCFI regulator would be responsible *only* for financial firms identified as such, and would work closely with function-based regulators responsible for all other financial intermediaries. The dedicated LCFI regulator would encompass all of the constituent functional areas of regulation-by-function, but at the same time be familiar with the consequences and the complex and network-based linkages between the various financial activities that arise within LCFIs – complexity that itself could lead to systemic failure.

Most importantly, the regulator would have the power and the obligation to ensure that LCFIs operate consistently with priority attention to the institution's safety and soundness, even if this can only be achieved at the cost of reduced growth and profitability.

Policy Recommendations

As discussions of regulatory reform go forward, we recommend the creation and empowerment of a dedicated regulator for LCFIs. This would require that LCFIs be identified as such and subjected to an enhanced level of regulation to ensure their safety and soundness. Identification of those LCFIs to be subject to special regulation would be based on measures of size in combination with measures of complexity or interconnectedness. The LCFI regulator would specifically focus on capturing key risk exposures and their interlinkages within the financial system, and on avoiding many of the risk management failures and governance problems that characterize the current crisis. The dedicated U.S. LCFI regulator would necessarily have to be linked as seamlessly as possible to his/her counterparts in the Basel Accord participant countries so as to insure an effective level of global coordination and prevent regulatory arbitrage. Of equal importance, the LCFI regulator, using information collected in this role, will be able to price more accurately the government guarantee that inevitably underpins LCFIs. Such pricing may facilitate setting a fair baseline insurance cost or premium that is linked to the asset size and institution-specific risk attributes of individual LCFIs, coupled to surcharges based on measurable systemic risk exposures.

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