If Barack Obama Could Achieve Only One Financial Reform, *What Should It Be?*

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It is often said that new American presidents who attempt to achieve too many goals overnight usually fail—that they need instead to spend their political capital on confronting initially a relatively small number of issues. Eventually, they can broaden their agenda. If President Obama asked you to name the most urgent financial reform, global or domestic, needed to rebuild the credibility of our financial system, what would you tell him?

President Obama, *The White House, January 29, 2009.*

WHITE HOUSE PHOTO BY PETE SOUZA

Outlaw credit default swaps.

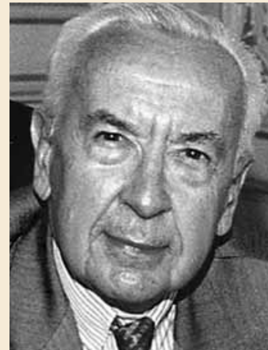
BARTON BIGGS
Managing Partner, Traxis Partners, and author of* Wealth, War and Wisdom *(Wiley, 2008)

I'm no student of regulation, but the new administration would do our financial system a favor by outlawing credit default swaps. Originally designed as a form of insurance against companies defaulting on debt, they have developed into an easy way to short bonds and drive down stock prices.

Unlike shorting stocks where the potential gain is defined but the potential loss is infinite, CDSs are the opposite. In buying a CDS contract, the risk is limited but the profit potential is unlimited. If an adverse development is expected, possible, or even hoped for, the most efficient strategy is short the stock and then buy the CDS.

Thus, the existence of CDSs encourages bear raids. Driving up the CDS exerts downward pressure on the price of the underlying bond because as the imputed financing cost of the issuing company rises, its prospects, particularly if it is highly leveraged, deteriorate rapidly.

Last fall, bear raids by hedge funds, prop traders, and speculators intentionally drove up the prices of the CDSs of Lehman, AIG, and Merrill Lynch and drove down their common stocks to bankruptcy levels. Morgan Stanley, Goldman Sachs, Citicorp, and Bank America have so far narrowly escaped a similar fate. The same CDS buyers were short the underlying stocks and sometimes had sold short-dated, deep-out-of-the-money puts. These are bear gang raids, harmful to the financial system, and CDSs should be outlawed. The great financial panic of 2008 probably would have occurred anyway, but it would not have been as desperate.



Follow the Group of Thirty report.

JACQUES DE LAROSIÈRE
Advisor to the Chairman, BNP Paribas, and former Governor, Bank of France

Follow the recommendation of the Group of Thirty report that was recently published under the leadership of former Federal Reserve Chairman Paul Volcker. The report, "Financial Reform: A Framework for Stability," offers recommendations for the needed restructuring of financial institutions and markets.

Accept the supremacy of the International Monetary Fund above that of the Federal Reserve!

JACQUES ATTALI
President, PlaNet Finance, and former President, European Bank for Reconstruction and Development

Reestablish sensible incentives.

DINO KOS
Managing Director, Portales Partners, and former Executive Vice President, Markets Group, Federal Reserve Bank of New York

The single most important overarching reform is to reestablish sensible incentives for those firms and individuals participating in financial markets. The past cycle exposed deep flaws with how incentives had evolved and led financial institutions to take on large and ultimately imprudent risks.

In the old system, banks made loans and lived with the consequences. In the new system, those originating loans sold them to firms who packaged, securitized, and sold them to investors. The originators and packagers were paid based on volume, not on how the loans performed. Wall Street firms had a vested interest in "feeding the collateralized debt obligation machine" and so lowered underwriting criteria for loans they were willing to buy from originating lenders. Overly generous compensation packages reinforced those trends and magnified the risks at the height of the cycle.

Meanwhile, investors did not have the capacity to evaluate and analyze the risks embedded in complex products sold by Wall Street. Investors relied on rating agencies, not recognizing that they too were compromised.

This cycle has exposed a market failure caused by those misaligned incentives. Restoring those incentives should be at the top of the agenda. That implies preventing mortgage bankers from selling loans without recourse. They need to have "skin in the game" long after the loan has been securitized. Similarly, Wall Street firms that package loans into asset-backed securities must share in any losses. Volume alone cannot determine how firms in the intermediation process get compensated. There must be positive incentives for prudent underwriting.

Rating agencies play an influential role in the investing process, but they must be reformed and subject to greater scrutiny. That may involve formal regulation, but it need not. It may be sufficient to change the compensation model. If the assumption is changed so that investors pay for their services, the most apparent conflict of the current model is eliminated. At minimum, the formal Nationally Recognized Statistical Rating Organizations (NRSRO) designation should be eliminated.

Restore the flow of credit.

SAMUEL BRITTAN
***Columnist,* Financial Times**

President Obama does not need me or any of *TIE*'s distinguished contributors to tell him that the most urgent financial requirement is to restore the flow of credit from the banking system to the corporate and personal sector.

But there is room for a debate on more basic reforms to reduce the likelihood of the present credit crunch recurring.

This is not the time to push one's pet ideas. In my case, it would be to establish a 100 percent reserve banking system on the lines long advocated by a distinguished economist of the 1930s and 1940s, Henry Simons. But I have no illusions that this would prevent other financial institutions from granting excessive credits along now familiar lines.

The most fundamental required reform is to broaden the mandate of the Federal Reserve so that it covers asset bubbles as well as consumer price stability, output, and jobs. The fact that this is now the fashionable cry should not deter one from joining it. What is fashionable may on occasion be correct. Now is not the time for brilliant originality.

Ideally, central banks should operate under "constrained discretion." That is, they should be given a definite mandate by governmental authorities and left to their discretion on how to carry it out. But we know too little both about what an asset objective should cover and how to set numerical target for it for such a course to be feasible yet.

Inevitably, the Fed will have to feel its way and learn by experience before it can be given any precise presidential or congressional objective. This will be easier in the case of the Fed than of other central banks that are now constrained by specific consumer inflation targets. The United States is still important enough for a new policy stance by it to give a lead to the world's main monetary authorities.

Combine all the financial regulatory agencies into one unified body.

MAURICE R. GREENBERG
Chairman and CEO, C.V. Starr and Company

The most important change President Obama could make for the financial system at this early point in his administration would be to combine all the financial regulatory agencies into one unified regulatory body. At present, commercial and savings banks are regulated by one or more of the following: the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and various state banking departments. Securities are regulated by the Securities and Exchange Commission but options and futures on publicly traded securities are regulated by the Commodities Futures Trading Commission, which also regulates trading in commodities. Hedge funds and new financial instruments such as credit default swaps are effectively unregulated.

This new body would be charged with providing an effective system for safeguarding the public interest in all these areas while at the same time not stifling the innovation that has been characteristic of our financial system. We would propose that this new single regulatory body be guided by an advisory board that would include leading executives from financial services companies along with lawyers, accountants, and academics with financial markets experience.

This group would be charged with the responsibility of advising the new regulatory body on the impact of any new proposed regulation on the financial system, and thus avoiding any unintended adverse consequences. For example, the advisory group might suggest a phase-in period of three years for any new regulations to allow the financial system time to adjust without any dramatic adverse impact on the public interest. This new regulatory body would simplify the cost and effect of regulation and prevent gaps in regulation from harming our financial system. The Financial Services Administration in the United Kingdom has achieved this result.

Revive the securitization market.

L. WILLIAM SEIDMAN
Chief Commentator, CNBC, and former Chair, Federal Deposit Insurance Corporation

The securitization market must be revived since a large portion of consumer loans are financed using bundled loans, or securitizations. This type of financing supplies most of the funds for student loans, auto loans, credit card balances, and housing (through Fannie and Freddie).

Today, the securitization market has collapsed. Losses on bad old securitized loans have frightened potential investors from investing in new ones. Confidence in securitization was undermined because the process was essentially unregulated and subject to much abuse. For example, in the subprime mortgage market, a broker could originate loans, get paid his commissions, and sell them as part of a securitized pool of loans, all the while not retaining any financial interest in them.

Bankers created many securitized pools in off-balance-sheet entities (SIVs or structured investment vehicles) and sold the entire pool. Without any remaining interest in the product, they passed along all the risk.

What's needed is one or more private entities whose purpose is to purchase mortgages and securitize them, creating "insured securitized vehicles." In order to provide reinsurance for the private-sector mortgage securitization corporation, the government could, for a fee, offer back-

ing on conforming securitized loans. This government reinsurance agency would insure proper standards for products sold. Some may recognize this proposal as quite similar to one presented by former Secretary of the Treasury Paulson as a way to replace Fannie Mae and Freddie Mac. The advantages of the new plan: very low cost to government, market quality controlled by oversight of both the private sector and government, can be used for any appropriate consumer financing, and eventually government insurance can be reduced.

If we can create insured securitized vehicles, we can go a long way towards fixing the financial mess and maybe even delay the next big financial mess.

Address "too big to fail."

GARY STERN
President, Federal Reserve Bank of Minneapolis

The most critical issue to address to restore credibility to our financial system is "too big to fail" (TBTF). TBTF is unfair competitively and, more importantly, contributes to excessive risktaking and to financial and economic instability. Moreover, the TBTF problem has been magnified by the expansion of the financial safety net during the current crisis.

Policymakers choose to protect the uninsured creditors of large financial institutions because of deep concern about significant spillover effects on other institutions, financial markets, and the overall economy. To rein in TBTF in an effective, credible way, potential spillovers must be identified and contained prior to the onset of financial turbulence. It is not possible to accomplish this with conventional supervision and regulation. Instead, we have advocated Systemic Focused Supervision, a three-pronged program. The first step is identification of the sources of spillovers among large financial institutions and between such organizations and financial markets, including but not limited to direct exposures between the firms, common exposures, and inadequate resolution regimes. Second, enhanced prompt corrective action must be taken utilizing objective, market-based signals to close institutions before they can impose large losses on others. And third, communication of this new regime needs to be very clear so that uninsured creditors understand that they are at risk of loss, thus enhancing much-needed market discipline. (These views are my own and are not those of the Federal Reserve.)

Clean banks' balance sheets, restore their capital, and increase disclosure and transparency.

GUILLERMO ORTIZ
Governor, Bank of Mexico

To restore credibility, time is of the essence. Any regulatory reform would consume more time than is available to prevent a worsening of the current situation. Hence, I would like to differentiate between immediate actions needed to restore credibility and regulatory reforms that might require time to be drawn up and implemented.

To restore credibility, the Obama administration should have a clear, credible, and attainable plan of action. On the basis of the experience of the Mexican crisis, this action plan should be aimed at cleaning banks' balance sheets, restoring their capital, and increasing their disclosure and transparency.

Banks cannot resume their role as financial intermediaries until their management is freed from dealing with troubled assets and the public perception of their solvency is changed. The most expedient way to attain these goals is to reestablish the Troubled Assets Relief Program's original aim: to purchase banks' troubled assets.

In the process, the U.S. authorities should avoid any temptation to engage in regulatory forbearance. Capitalization regulation should be strengthened (that is, no accounting facilities of any kind). Troubled assets should be valued at close to market prices. Shortages of bank capital should be compensated for with share

issuance to any investor willing to participate (foreign or domestic). If needed, the government should temporarily acquire shares.

Regarding regulatory reforms, I am convinced that what the United States needs most is a single financial regulator under the aegis of the Federal Reserve. This regulator should have the attributes of the five existing regulators of deposit-taking entities (the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration), as well as the Securities and Exchange Commission. Extending the supervisory reach to the entire financial system might not be feasible or desireable. However, eliminating the fragmentation and arbitrage that occurs among current regulators should be a priority.

Restore the ability to fail.

ALLAN MELTZER
Visiting Scholar, American Enterprise Institute, and Professor of Political Economy, Tepper School of Business, Carnegie Mellon University

President Obama should recognize that in its ninety-five-year history, the Federal Reserve has never announced or implemented a lender-of-last-resort policy. And it hardly ever, almost never, allows a large bank or financial firm to fail. When it rashly changed this policy for Lehman Brothers, it created great uncertainty. In this era of rational expectations, this is the opposite of good policymaking.

One part of its new policy should extend FDICIA (the Federal Deposit Insurance Corporation Improvement Act of 1991) to all financial firms, another should require the Federal Reserve to implement FDICIA, and a third should declare that "too big to fail" is too big. "Too big to fail" encourages excessive risk taking with losses going to the taxpayers. Capitalism without failure is like religion without sin; it doesn't work.

Address the problem of "too big to fail."

THOMAS M. HOENIG
President and Chief Executive Officer, Federal Reserve Bank of Kansas City

Regardless of what regulatory structure we might devise, it is evident that the largest financial institutions in the United States and globally have become too large, too complicated, and too politically powerful to be successfully regulated on a sustained basis. One of our most immediate priorities therefore must be to address the problem of "too big to fail."

This is an issue that I have raised many times in the past, only to be told TBTF does not exist, or is inevitable and more efficient for the global economy, or can be managed. The events of the past eighteen months have proven otherwise. Around the world, the once-implicit guarantees on the debt and even some of the equity of these largest firms have become explicit not just for banks, but for select nonbank financial firms as well. The cost to taxpayers goes beyond the direct costs of propping up TBTF firms and includes the indirect costs of lost output, misdirected resources, displaced workers, and reduced household wealth. Moreover, every competitor of TBTF firms is put at a disadvantage because they still must bear the downside risks.

An important discussion that needs to occur is how we might break up these organizations into smaller, less dominant firms within our financial system. It is possible and such action would systematically enhance stability within our system. Alternatively, we must impose constraints on financial firms as they approach TBTF. For example, we would impose a tax once a firm reaches a threshold size, or require increasingly lower leverage ratios on firms as they grow to remove the incentive for unmanageable concentration. We must also develop a robust resolution process extended to all financial firms regardless of size. Such a process must be faster than the current bankruptcy process, require shareholders to lose their entire investment, and require that unsecured debt holders have reduced access to their funds through a crisis. It also must allow for the removal of senior man-

agement and the appointment of new, qualified management to conduct operations necessary for preventing a national liquidity crisis and maintaining a fully functional payments system.

Of course, given the global nature of financial markets, it will be difficult, although not impossible, for any individual country to tackle TBTF on its own. Thus, this is the issue that merits a coordinated global response if we are to reduce the likelihood of future systemic crises in our financial system.

There is already a proven three-part strategy available.

C. FRED BERGSTEN

Director, Peterson Institute for International Economics

Any effective reform of U.S. financial regulation must be firmly imbedded in a new international regulatory regime. The current crisis has underlined the globalization of financial markets and thus the inherent ineffectiveness of seeking to supervise them on purely national bases.

At the same time, there is no international legal structure to impose and enforce financial regulation nor is there likely to be one for a very long time (if ever). Hence, the challenge for policy is to find a blend of reforms that is both national and international.

There is fortunately a proven three-part strategy for reconciling these seemingly incompatible goals. First, the appropriate international group(s) agrees on a best-practices template that would effectively cover all relevant classes of transactions and financial institutions. Second, each country modifies its national regulations and supervisory mechanisms to incorporate those globally agreed standards. Third, the international group(s) monitors the national implementations to promote their maximum adherence to the proposed benchmarks. The result is a dynamic interactive process through which national regulatory and supervisory systems approach (probably asymptotically) global best practices.

This strategy was implemented with great success in the adoption of an international banking standard, as initially proposed by my colleague Morris Goldstein, after the Asian financial crisis a decade ago. Weak banking systems were a common element of that episode and a central element of the policy response was to strengthen them substantially. Hence the Basel Core Principles were agreed at the international level, used as a basis for national reform in the crisis countries and many others, and subsequently monitored by the International Monetary Fund (including through its Financial Sector Assessment Program). Largely as a result, those countries now have much stronger financial systems and are therefore far less devastated by the global crisis.

It will be harder to implement the reforms that are needed now because the financial markets that need new regulation are much more complex than simple banking systems, because many more countries must be covered, and especially because the rich countries (including the United States) that require reform have traditionally thought of their own financial regimes as already incorporating global best practices. This was clearly not the case, however, and the proposed three-part process is essential to bring national as well as global regulatory systems into the twenty-first century.

Repeal or suspend mark-to-market accounting.

STEVE FORBES

Chairman and Chief Executive Officer, Forbes. Inc.

The answer is simple—repeal or suspend mark-to-market accounting that is unnecessarily devastating bank and life insurance balance sheets. If we had had such a regulation in the early 1990s, when we last had a banking crisis, virtually every major commercial bank would have been destroyed and we would have suffered a depression. The mark-to-market overhang is crippling banks' ability to lend as well as inhibiting the creation of new banks which would help fill the lending gap as old banks deleverage.

End the role of the Fed in the bank supervisory process.

CHRISTOPHER WHALEN
Senior Vice President and Managing Director, Institutional Risk Analytics

The key change in the area of financial regulation that the Obama Administration needs to make is something the President has already alluded to during his campaign, namely ending the role of the Federal Reserve Board in Washington in the bank supervisory process. The Fed has become entirely corrupted over the past decade or more, advocating the growth of risky mortgage lending, over-the-counter derivatives, and off-balance-sheet financing vehicles for the largest banks, activities that we now know are unsafe and unsound and thus contrary to existing law.

The degree of regulatory capture of the Fed by the largest New York money center banks is illustrated by the appointment of former Federal Reserve Bank of New York chief Timothy Geithner to be the next Treasury Secretary. Geithner, and his political sponsors Robert Rubin and Lawrence Summers, are directly responsible for a strategy to bail out the largest banks, both equity and debt, at the expense of the banking industry and the taxpayer. The bailouts of the shareholders of Bear Stearns and AIG are reckless and illegal decisions that have confused and terrified global investors, who look at the treatment of Lehman Brothers and Washington Mutual, by comparison, and rightly see inconsistency and political favoritism towards Goldman Sachs and Morgan Stanley.

Only by ending the Fed's conflicted, politically tainted role in U.S. bank supervision can we re-balance the political equation when it comes to safety and soundness regulation in the United States and thereby restore our badly damaged credibility with the rest of the world. When we rebuild the U.S. economy, it will be on the regional and community banks for which the Fed has shown complete contempt, not the insolvent money centers in New York which must eventually be restructured and liquidated.

Add the macro-prudential dimension to the existing system of exclusively micro-prudential regulation.

JOHN WILLIAMSON
Senior Fellow, Peterson Institute for International Economics

There is no single reform that could rebuild a credible financial system. Nor does a recognition that it is a mistake to attempt too much imply that one should seek to limit reforms in this way. What is a mistake is to seek to do too many different things, not to do one of them sufficiently thoroughly to have a chance of succeeding. Regulatory reform is clearly on the international agenda for this year, but it will be effective only if the United States is engaged, so one hopes that Barack Obama makes the effort to search for an appropriate answer.

What is needed (as argued in the new Geneva Report by Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash Persaud, and Hyun Shin) is a system of regulation that adds the macro-prudential dimension to the existing system of exclusively micro-prudential regulation. Right now one wants banks to lend, so the 8 percent capital-asset ratio that was determined in the past on micro-prudential grounds should be multiplied by a small fraction to determine the amount of capital that banks need to hold. As markets recover, this multiple should approach one, and if and when a new speculative bubble threatens to develop, it should exceed unity. Because supervisors are also human and therefore subject to fantasies about bubbles going on for ever ("this time it's different"), the multiple needs to be set automatically by formula.

But one also wants financial intermediaries to finance the holding of long-term assets by issuing equally long-term liabilities, so that they do not find themselves in the position of all too many financial institutions in this crisis when the short-term market closed down. This could be encouraged by varying the required capital-asset ratio so that it increases the greater the maturity mismatch. The present system of looking solely at the asset side of the balance sheet when determining capital-asset ratios is an invitation to disaster.

There are other things that need doing too, like reviving liquidity ratios. But if Obama encourages the installation of well-designed macro-prudential regulations multiplied by a micro-prudential capital-asset ratio that increases with maturity mismatches, we will be on the way to having a serious system of regulation.

Prevent the sale of CDOs unless the originator can demonstrate how the CDO can be unbundled into the original loans.

ROGER M. KUBARYCH

Chief U.S. Economist, UniCredit Research, and Adjunct Senior Fellow, Council on Foreign Relations

Stop the sale of any complex security likely to end up being "toxic." To accomplish this, the U.S. government should create a new regulatory body, a kind of "Food and Drug Administration" whose mission is to protect the public's financial health by assuring safety, efficacy, and security for complex financial products. It would have one mandate: Prevent the sale of collateralized debt obligations unless and until the originator can demonstrate how a proposed CDO can be unbundled into the original whole loans. Conventional pass-through securities would pass the test easily. For familiar, but somewhat more complicated mortgage-related securities, like PACs, TACs, IOs, and POs, it may take some effort. The worst offenders—CDOs laden with conditional optionality through financial derivatives or otherwise—would face stern tests, both market and legal. Only those that clearly can be unbundled would pass. Sale of those which fail would be deemed an unsafe and unsound practice, with sanctions against offending banks.

This reform would go far in preventing the next meltdown without stunting worthwhile financial innovations, only those badly designed and not thought through. Ideally, it should be developed at the international level, with U.S. regulators working in coordination with the Bank for International Settlements, the Europeans, the British, and the Japanese.

Naturally, it would work best if the regulators banned abusive mortgages, reestablished old-fashioned loan-to-value requirements, and made potential borrowers substantiate their income and asset declarations with tax returns and bank statements. But I don't think these common-sense steps rise to the level of "an important regulatory reform." Rather, it means merely doing their jobs the way they should have been done all along.

Reform economic and financial governance.

JIM O'NEILL

Head, Global Economic Research, Goldman Sachs International

There is clearly evidence for reform of an overwhelming number of structures of the financial scene, but as the question implies, trying to achieve too much too soon might be dangerous.

To choose just one, I think the case for reform of the world's system of economic and financial governance lies at the heart of the problems. While many regulatory factors have been caught offside by the current crisis, one can argue that its underlying cause has been the persistent imbalances between the United States and the rest of the world, including the major emerging nations, led by China. If there had been a more effective forum than the G7, G8, and the post-World War II order of the International Monetary Fund, then perhaps these imbalances might not have persisted for so long.

With President Obama now in place, and Larry Summers as his key economic advisor and one of the architects of the G20, there is a perfect opportunity to use the G20 to establish a much more representative order for the system of managed capitalism that is now going to be necessary to deal with both the current crisis, and the changing order of the world economic hierarchy. Without leadership from Washington, this cannot happen, and it is clearly necessary.

Require standardization of all forms of securitized debt.

HARALD MALMGREN
Malmgren Global LLC

To get credit flowing again, injecting capital into troubled banks may help, but in recent years banks provided only a fifth of the financial flow which fueled economic expansion. Most financing came from non-bank institutional investors such as pension funds, insurers, hedge funds, and mutual funds, through seemingly limitless demand for purchases of securitized debt issued by banks and brokerages. In 2007, this river of demand dried to a trickle of fire sales at valuations of pennies on the dollar. The market virtually shut down as buyers lost trust in both issuers and in their complex debt products. The huge market for "trust me" assets came to an end.

U.S. officials have repeatedly stressed that restoring the functionality of the securitization process is critical. One idea floated is that banks be required to keep a substantial portion of equity in debt securities they sell—keeping "skin in the game." But that would not be sufficient. Debt products which bankers sold in recent years were complex assortments of asset classes of varying degrees of risk that were cobbled together by mathematical wizards employed by bankers. CDOs and other forms of securitized debt were "one-off," unique products. They were designed on an assumption that the market would remain liquid under any conceivable circumstances. When the entire market became illiquid, the math broke down.

To restore trust, and revive the market, the product needs to be changed. The single most effective regulatory reform would be to require standardization of all forms of securitized debt: No mixing of asset classes or risk classes, simple and clear description of contents embodied in the debt security, and name of issuing institution along with a serial number to track the actual originator/designer. The Securities and Exchange Commission would require that any such "collateralized" debt security be treated in the same way as any other security issued by publicly listed companies, carrying the same civil and criminal liabilities. In the event that debt instruments were found to be not as stated, there would be both civil and criminal recourse. The role of rating agencies would be made simpler if the products were standardized—and issuers would no longer need to seek assistance from raters in valuing complex mixed-risk products. Because of potential future liabilities, sellers would no longer be able to treat such sales as a means of transferring all risk.

Our government is now trying to leverage public money through partnership with private investors to revitalize the financial marketplace. By regulation, change the product so that buyers of debt no longer have to rely on sellers' reputations, nor on unreliable mathematical risk models, nor on raters with inherent conflicts of interest.

Adopt the Swedish "good bank/bad bank" approach.

DESMOND LACHMAN
Resident Fellow, American Enterprise Institute

Rebuilding the credibility of the U.S. financial system will be a Herculean task and seeking a single regulatory reform to do so would be a fool's errand. For the present, deep lack of credibility is not so much an issue of regulatory inadequacy. Rather it is one of a lack of solvency of many important financial institutions and a lack of transparency that makes it difficult to ascertain the severity of that insolvency.

My advice to President Obama would be to make a clean break from the failed policies of the previous Administration that treated the financial sector crisis more as a liquidity problem rather than as a solvency problem. The overarching objective of financial sector policy must be to quickly distinguish between solvent institutions, which should be supported, and insolvent institutions, which should be forcibly restructured. In implementing such a policy, the Administration would be well advised to adopt the Swedish "good bank/bad bank" approach to the problem rather than to go down the failed Japanese route of the 1990s. The Administration would

also be advised to refrain from pretending that bank restructuring can be done on the cheap.

I would also caution President Obama not to expect too much from regulatory reform, especially if we are to have a financial system that continues to be dominated by a small number of institutions that are too big to fail. I would propose that he take advantage of the present financial sector crisis to create a more competitive banking system by breaking into smaller pieces those large banks that need to be forcibly reorganized.

Reexamine mark-to-market rules.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Reforms usually come as a coherent package of actions, not one action at a time. The same should be true of reforms in financial regulation. For instance, financial leverage (ratio of assets to capital) should be limited in institutions large enough to have systemic effects. However, if a single reform is needed now, it is the accounting requirement to "mark-to-market" all financial assets, even when there is no effective market. This accounting standard requires simulating a market when there is none, either with models drawing on fragments of information, or on the basis of transactions that may in fact have been one-offs forced by circumstances. Anyone in such dire need of cash that he or she needs to sell the house by the end of next week must generally accept a price far lower than the price attainable if the house can be on the market for six months. Illiquid assets are illiquid, and market valuation depends critically on the circumstances of sale. This is generally true of immature venture capital investments, and of bank loans to business, and it is also true of once-marketable securities when for whatever reason the market disappears.

Accounting theologians have persuaded themselves and others that mark-to-market is necessary for transparency. Such is not the case. Indeed, when valuations are based on obscure models, or one-off transactions, transparency is reduced, not enhanced. There is no reason, in the name of transparency, to try to put everything in a firm's balance sheet and operating statement. Illiquid assets can be valued at cost and described fully in text, leaving it to analysts rather than accountants to estimate how to value them. Of course, this change in practice should apply to up markets as well as to down markets, so firms cannot increase the reported value of their illiquid assets, and their capital, on the basis of dubious models.

Many otherwise sound firms could become technically insolvent under today's accounting rules, with dire consequences for the economy. That does not represent good economic policy.

Take into account how markets best work.

SUSAN M. PHILLIPS
Dean and Professor of Finance, George Washington University School of Business, and Former Member, Board of Governors of the Federal Reserve

I would rethink the way we go about writing regulations to take into account how markets best work and the economic incentives of market participants. For the past seventy years, we have made incremental changes to financial regulatory structures for narrow purposes, sometimes with a cost/benefit analysis, but generally not thinking through potential externalities. Market participants often look for ways to end-run the regulation or engage in regulatory arbitrage, undermining the purpose of the regulation or creating unintended consequences.

Examples of this regulatory economic distortion are abundant. Prohibiting short sales inhibits the transparency of accurate market prices. Requiring futures contracts to be traded on exchanges has created a market for economically similar, but not standardized, products to be traded over the counter. Capital requirements for banks which penalize the recognition of mortgages on

balance sheets has created an off-balance-sheet world of mortgage brokers and conduits.

To the extent that economic incentives can be integrated into regulatory design, we may be able to improve market functioning, or at least not impair it. For example, when disclosure of OTC securities transactions by price and size were required (originally resisted by traders), market participants gained confidence in the OTC markets and volume ballooned. Similarly, audit trails for exchange-traded futures and options contracts (originally resisted) eventually created public confidence in the integrity of the markets. Trading volume has continued to increase and those markets are now seen as safer with transparency, compliance, and enforcement capabilities, delivery protocols, mark-to-market and clearing houses to assure counterparty credit.

But regulatory systems must be accompanied by compliance and enforcement capabilities to assure that free riders don't appear, disadvantaging the compliant market participants. This balancing process helps locate the "right" regulatory structure where all market participants have a fair shot at contributing to capital formation, resource allocation, and risk management.

Restore government-insured commercial banks to their core roles as financial intermediaries.

WENDY DOBSON

Professor, Institute for International Business, Joseph L. Rotman School of Management, University of Toronto, and former Associate Deputy Minister of Finance, Canada

The single most important reform to help rebuild the credibility of the financial system would be to restore government-insured commercial banks to their core role as financial intermediaries. The function of commercial banks is to take deposits and provide credit to households, businesses, and governments. Accordingly, they should have one prudential regulator, who ensures their risk appetites and leverage are appropriate to this core function. In the wake of the current crisis, the surviving banks will probably be large in size, but the complexity of their businesses should be reduced to focus primarily on their intermediary role. They should be required to build up their capital during good times to cushion them during downturns. This one reform would make them less risk-prone, reducing their returns and their compensation packages, but making them more sustainable. International cooperation among governments will be required to ensure that all major financial markets adopt similar reforms, thereby reducing the opportunities for regulatory arbitrage. In the United States this reform would separate the commercial banks from riskier capital market institutions that are subject to less regulation and are entitled to the returns—or losses—incurred by their risk-taking.

Temporarily nationalize the banks.

TADASHI NAKAMAE

President, Nakamae International Economic Research

President Obama should temporarily nationalize banks. This should not be seen as a socialist solution, as it implies that banks will be re-privatized after a period of time. Nor should it be viewed as a piecemeal solution. All banks with large amounts of toxic assets on their balance sheets, and this probably covers most of the banking industry, should be nationalized.

This would accomplish three things simultaneously. First, it would enable the government to sever bad assets and an equivalent amount of liabilities from the banks' balance sheets. Banks would become smaller, but would be completely free of bad assets. Second, healthy banks would be able to secure fresh funds as re-privatized entities and would be able to lend easily again. Third, the government can use its status to secure funding so that it can continue to rollover the funding for these bad assets until they can be sorted out.

This wholesale approach gives the government precious time to gauge the value of the so-called toxic assets and decide how much capital banks need. The government would no longer have to make hasty guesses about

the value of complicated derivatives that have gone sour in an illiquid market. Moreover, if say 90 percent of banks (and their bad assets) were nationalized, many of these derivatives could be cancelled out since many banks would have been counterparties in such deals. The strategy would also enable "good" banks with clean balance sheets to establish business models that are profitable, making them appealing to investors, so that they can be re-privatized quickly. These proceeds would finance the eventual write-down of the bad assets, hopefully leaving the government—and taxpayer—with a net profit, or at least, with minimal losses. Unlike other measures, such as former Treasury Secretary Paulson's $700 billion "solution," this measure would not increase government debt.

The last point is critical. No crisis response should increase debt, be it the debt of governments, central banks, or private entities. Nor should interest rates should be lowered too much. Interest rates should continue to perform their normal role in a market economy. Otherwise, America could end up like Japan, which after its banking crisis, numerous hand-outs, and near-zero interest rates was left with overcrowded industries filled with dud firms. Extremely low interest rates enable weak companies to survive, and undermine efforts by healthier competitors to raise corporate profits that can be plowed into fresh capital spending, helping boost the economy. Moreover, a low interest rate policy coupled with government bailouts of private companies fosters inefficiency, which can easily become entrenched and impair its growth potential. It was the resulting decrease in revenue rather than an increase in spending that led Japan's budget deficits to inflate further. America, which already has enormous budget deficits, mostly funded externally, could face similar problems, to its great detriment.

Tackle the problem of over-the-counter derivatives.

LAURA BADIAN
Counsel, Arnold & Porter LLP

President Obama needs to address the root causes of the credit crisis and tackle the problem of over-the-counter derivatives, which present intolerable systemic risk. In 1998, Brooksley Born, a former Commodity Futures Trading Commission chair, warned of the dangers of derivatives, but her calls for Federal oversight went unheeded. Warren Buffett warned in his 2002 letter to Berkshire Hathaway shareholders that derivatives are "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Years of hands-off regulation of OTC derivatives, and excessive leverage at financial institutions, is one of the causes of the meltdown in our global financial markets.

Derivatives are beneficial if used to hedge the risk of economic loss from an underlying obligation, but excessive speculation and leverage can bring a financial institution—and indeed our entire financial system—to its knees. Credit default swaps, which are essentially "side bets" on whether an underlying credit instrument will default or a specified credit event will occur, were negotiated privately by parties outside of any regulated futures exchange.

To bring some adult supervision to this area and forestall another financial crisis, legislation requiring that credit default swaps be traded on an exchange or cleared through a central counterparty should be passed. Central counterparties help reduce systemic risk because they facilitate netting of offsetting positions, and the central counterparty absorbs the loss if a party defaults. Beyond that, the Gramm-Leach-Bliley Act should be amended to give U.S. federal regulators oversight over OTC derivatives. And rather than squabbling over whether the Securities and Exchange Commission, Commodity Futures Trading Commission, or the Federal Reserve should have regulatory authority, the SEC and CFTC should be merged and given authority to regulate OTC derivatives.

There is no single measure which must take center stage now.

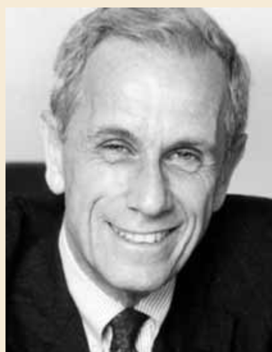
MANFRED WEBER
Chief Executive, German Banking Association

The best advice to the Obama administration for the challenging time ahead may be to always bear in mind the global impact of any specific reform. Financial market regulation is based on the perception

that open financial markets help to promote growth. However, dynamic markets need an effective framework of rules and regulations that is as resistant as possible to shocks and regulatory arbitrage. Whatever is done now should therefore always be judged by whether it complies with the principle of open markets and fostering competition and stability simultaneously. Experience shows that going it alone here causes more harm than good.

A look at the immediate political agenda shows that both in the United States and the rest of the world, the focus is still on fighting the immediate fall-out from the financial crisis. The three-pronged "rescue-restructuring-recovery" strategy often cited as a blueprint remains in phase one. This involves heavy pressure to take action despite inconclusive data. The task at hand now is therefore to critically review the steps taken to date and—where necessary—modify these to prevent a further market slide. Time will tell whether the adjusted Emergency Economic Stabilization Act that refocuses on purchasing assets will do the job. At any rate, the door is open now to a return of the much-needed confidence in the financial sector. However, while financial market stability is the overall objective, a clear exit strategy should also be kept in mind.

When it comes to the next possible steps, several policy options are on the table. All of them are of similar importance. Reforming the supervisory system in the United States is necessary, but it will not be optimal without international coordination of banking supervision and macroprudential stability analysis. And improving capital standards cannot be seen as being inferior to restoring the smooth functioning of the securitization markets. Policymakers around the world face a host of highly complex—and interdependent—decisions. There is no single measure which must take center stage now.



Designate one of the seven Fed governors as deputy chairman for coordination of regulatory issues.

STEPHEN AXILROD
Global Economic Consultant and author of **Inside the Fed: Monetary Policy and Management, Martin Through Greenspan to Bernanke** ***(MIT Press, 2009).***

If we have learned anything from recent experience, it is that regulatory issues need to be more directly taken into account in the formation of monetary policy, and vice versa. The genesis of the current credit crisis surely includes some interactive combination of monetary policies that were flawed, regulatory policies that seemed almost willfully careless, and a pervasive culture in the country that undid the common sense and prudence of borrowers and lenders large and small—the latter being to an important degree enabled by both monetary and regulatory attitudes.

To help remedy the situation, Congress should change the Federal Reserve Act to create a new position designating one of the seven governors of the Board as deputy chairman for coordination of regulatory issues. To do the job effectively, the person requires the stature of being appointed by the President for a four-year term subject to Congressional approval. He or she would report to Congress twice a year, would act as chairperson of a coordinating committee of major regulators (where both micro- and macro-regulatory issues would be reviewed), would make recommendations to individual regulatory agencies, and would of course bring regulatory issues and especially their macro-financial policy implications before the Federal Open Market Committee.

This person would be responsible for consistent well-coordinated oversight of the financial system and its stability: how its various components are adapting (for good or ill) as the economy and markets evolve and innovate; how the risk positions taken by individual firms are to be evaluated against the total risk exposure of their sectors (banks, securities houses, and so forth); and how the interactive dynamics across all firms and sectors are affecting the stability of the entire system. He would be the focal point for evaluating the macro-financial implications of micro-financial regulation and supervision. This would include evaluation of the overall risk exposure of banks or others to particular economic sectors (such as housing) and to each other, considerations about the need for moderating mark-to-market rules in light of longer-run values in exceptional circumstances, and perhaps arguments for undertaking countervailing cyclical modifications in normal capital ratios.

As well as bearing on use of monetary policy instruments, his role would also, I trust, help ensure a constructive feedback loop between monetary policymakers and those responsible for implementing regulatory policies. Presumably, both monetary and regulatory policies would improve. And something like the current situation—where the Fed has ended up imperiling its own balance sheet (requiring thereby various forms of government support) as a liquidity crisis turned into a very major solvency crisis—will become an aberration of the past.

A new approach to transparency.

SUSAN ARIEL AARONSON
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Global oil markets, like global credit markets, do not function according to the laws of supply and demand. Oil prices remain high and volatile, causing economic suffering. A new approach to transparency may ultimately yield greater stability.

Oil markets do not work efficiently for several reasons. First, we don't really know how much oil we can easily tap. Most of the world's leading exporting states are not open about their reserves. Several oil companies (notably Shell) have overstated their reserves. Second, world oil markets are tainted by corruption. Buyers and sellers of energy often conceal information about energy contracts and revenues. This information failure can lead to market failure and price volatility. This market failure can also undermine development. Policymakers in many petro-states use extractive royalties to invest in Swiss bank accounts rather than in their people. Third, consumers don't have the information they need to make good energy decisions. Many countries use subsidies to protect their citizens from rising fuel prices. These subsidies allow consumers to waste fuels as well as the numerous consumer items made from fossil fuels, such as plastic bags.

American policy reform won't make international oil markets function efficiently, but our policies can incentivize better behavior. First, Congress should approve legislation requiring extractive firms to publish what they pay governments for the right to extract resources. The United States should also provide support for new international accounting rules that will show energy firms how to disclose such rents. This will pressure governments to publish what they earn and help citizens demand greater accountability from their local officials. Over time these transparency reforms could reduce the opportunities for government officials to demand bribes from oil companies.

Oil may be the fuel that lubricates the world's markets. But the market for oil is too…greasy. Better governance could be a slick solution.