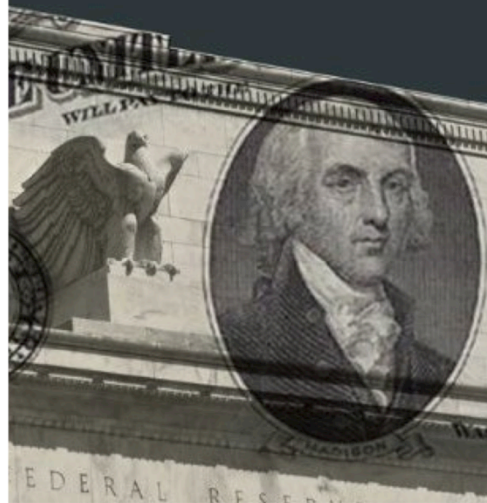




Guardians of Finance

MAKING REGULATORS WORK FOR US

James R. Barth, Gerard Caprio, Jr.,
and Ross Levine



Key questions about the financial crisis

- **What really happened?**
- **Why did it happen?**
- **How can we fix finance?**

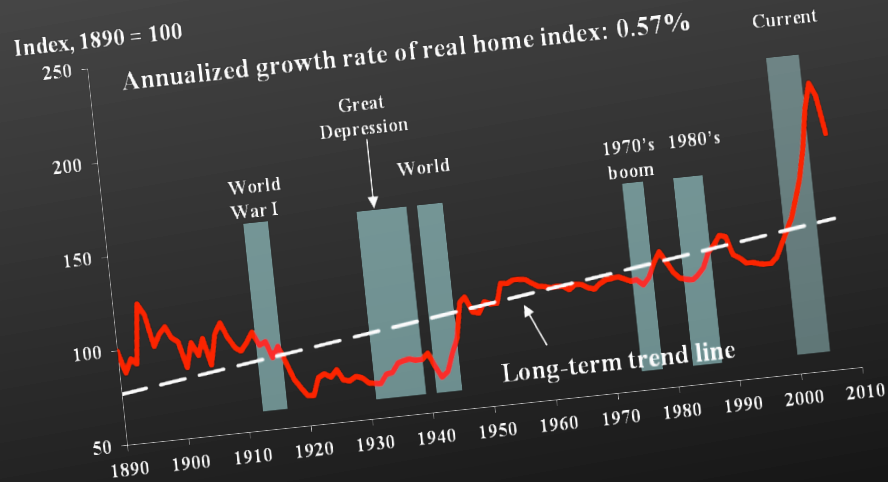
Our View

- **Regulators had the powers and the evidence, did not act**
- **Why not? Perhaps 'home field advantage'**
- **To prevent recurrences, need instant replay for regulators**

Clear Warning Signs

- **Destruction of information, skewed incentives (Ninja loans, leverage, record growth, pay levels, etc)**
- **Housing bubbles (US, Ireland, Spain, etc)**
- **Regulatory abdication across countries... including those in continental Europe**

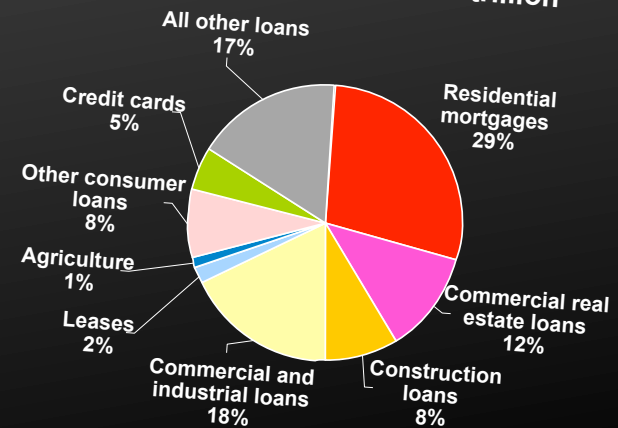
Housing boom and bust



Banks heavily in real estate

December 2007

Total bank loans = \$7.9 trillion



An accident or negligent homicide?

FDIC' s decisions and actions

Excellent at identifying problems.

- Identified what caused 79% of banks to fail years before they failed.

But, less effective at acting in the public interest.

- FDIC's own Material Loss Reviews note that 95% of the time it did not act promptly and correctively to address known problems.

**Result: more than 300 banks failed since 2007,
estimated cost \cong \$60 billion to FDIC.**

Were the Irish unlucky victims of the U.S. collapse?

We don't think so.

And they don't either: "the crisis was entirely homegrown."

Patrick Honohan,
Governor of the Central Bank of Ireland

Irish crisis was not unforeseeable

The root causes were:

“a regulatory approach which was and was perceived to be excessively deferential and accommodating ... ”
an unwillingness by the (regulator) to ... “rock the boat”
or “spoil the party” ...

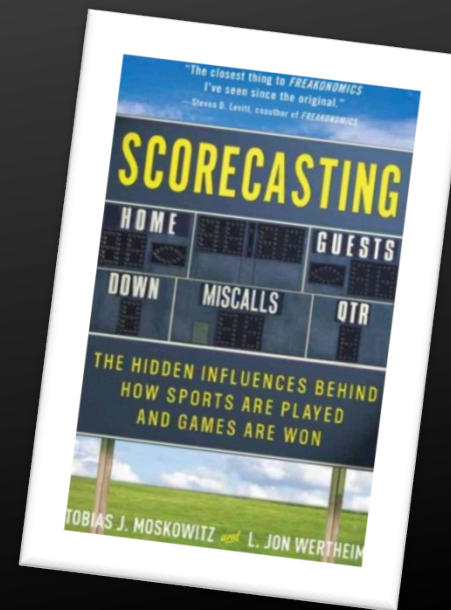
Governor Patrick Honohan
Central Bank of Ireland

Regulatory Bias Seems to Continue

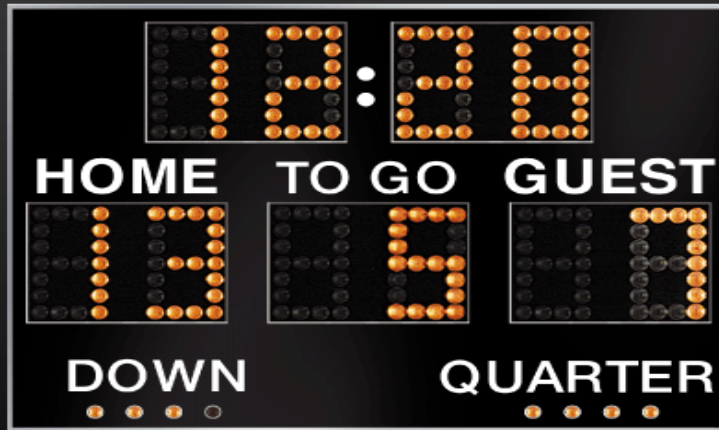
- **Regulators missed the Whale (not even close)**
- **Bank of Spain and audit allegations**
- **Standard Charter/Iran – federal regulators deferred**
- **LIBOR lies** - “Through all of my experience, what I never contemplated was that there were bankers who would purposely misrepresent facts to banking authorities,” Alan Greenspan.

Is it human nature?

An analogy from
“Scorecasting” by Tobias
J. Moskowitz and L. Jon
Wertheim.



Why is there a home team advantage?



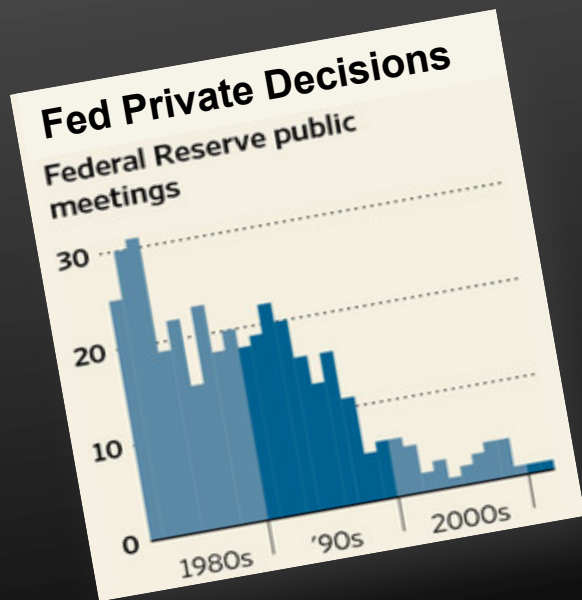
Is it human nature?

Officials are human, and sub-consciously strive to please the home crowd.

- Officials do not reluctantly change their stated views
- They genuinely adopt the crowd's view
- Conformity changes their actual perceptions

The financial services industry has the home field advantage.

The Fans who talk to the Refs



On Volcker rule and derivatives

Source: Wall Street Journal, February 21, 2012.

Lessons from sports

Electronic monitoring of balls and strikes, the challenge flag, and instant replay.

Reduce bias ... ex ante!!



How can we fix the system?

The public needs an informed, expert, & independent assessment of regulation. We need...

- Accountability
- Reduce importance of revolving door, political influence
- Avoid the comforting allure of simplistic ideologies
- Permit an informed debate
- Reduce bias

The Sentinel

Organization: Independent and expert

- Independent: of politics, markets, & budget
- Expert: resources of teams multidisciplinary experts

Power: Demand information

Responsibility: Provide independent, informed expert assessment of financial regulation

- No regulatory responsibilities



