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A SYMPOSIUM OF VIEWS

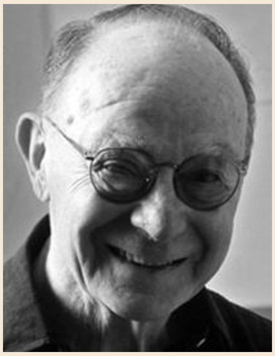
Is Regulation, or the Lack Thereof, Risking a Second Great Financial Crisis?

Is the lack of effective financial market regulation exposing the United States and the world to a second crisis? Are U.S. financial markets still something of a "financial casino" thanks to failure to implement fully the Dodd-Frank financial market legislation and the so-called Volcker Rule restricting bank proprietary trading?

Or is the opposite true? Does the threat of the Volcker Rule and the overall uncertainty of U.S. financial market regulation have the potential to dramatically reduce market liquidity?

To what extent is financial market regulation, or the lack thereof, risking a second global financial meltdown?

Over a dozen noted experts share their views.



Regulators always become captured by the large banks.

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

Crises have reoccurred throughout modern history. Nothing that legislators and administrators have done in recent years will change that. Most of the new regulation and the many new programs to make regulators responsible for judging risk and avoiding crises is well-intended but mistaken.

Before the 2008 financial crisis, the Federal Reserve Banks had scores of bank examiners in each of the largest U.S. banks. One of the leading examiners told me that they did not object to a single transaction. The Board of Governors approved off-balance-sheet entities that held mortgages and mortgage-backed securities but little if any equity capital. The Securities and Exchange Commission greatly increased the leverage of investment banks. Regulation failed.

Dodd-Frank gives the Secretary of the Treasury authority to decide whether a bank is too big to fail. That does not change past practice. Can anyone believe that in the midst of a crisis, the Secretary will decide to let a large bank or financial institution fail? Everyone will remind the Secretary of Lehman Brothers.

I find no reason to believe that, with the passage of time, the regulators would not again be captured by the large banks and financial firms.

The right way to reduce risk is to make the risk-takers bear the risk. Instead of hundreds of regulations, I offer four principles to reform banking and financial markets. The principles shift responsibility back to the bankers. With increased equity capital, the principle stockholders will insist on prudent decisions.

First, we need a clearly stated rule, publicly announced, governing the lender of last resort. In one hundred years, the Federal Reserve has never announced any rule or principle governing lender-of-last-resort policy.

Second, we should return to protecting the payment system, not the banks or financial institutions.

Third, by implementing the first two rules, we will prevent problems from spreading to other institutions that hold collateral acceptable for discount under the lender rule.

And last, we should require regulated very large banks to hold a minimum of 15 percent equity capital against all assets. This is the rule in the bipartisan Brown-Vitter bill.

The system is safer, but it would be premature to declare victory.

E. GERALD CORRIGAN
Managing Director, Goldman Sachs Group, and former President, Federal Reserve Bank of New York

The aftermath of the financial crisis of 2007–08—in economic, financial, and human terms—has been a slow and frustrating process as we strive to restore more normal patterns of economic growth while at the same time putting in place the essential building blocks that will secure a more stable financial system.

Given the complexity of the causes and contributing factors to the crisis, it should not surprise us that the post-crisis legislative and regulatory reform agenda is equally, if not more, complex. For that reason, some time ago I concluded as a matter of priority that the most pressing building blocks for enhanced financial stability were four in number as follows:

- First, the Basel standards for capital and liquidity, which should be viewed as complementary disciplines by individual institutions and their supervisors.

- Second, the development of a workable framework of recovery plans (often called living wills) on the part of troubled institutions and their supervisors to stabilize such institutions and promote their recovery short of bankruptcy or failure.

- Third, the development of a comprehensive framework of enhanced resolution authority that would permit the orderly wind-down of seriously damaged systemically important financial institutions without reliance on taxpayer money.

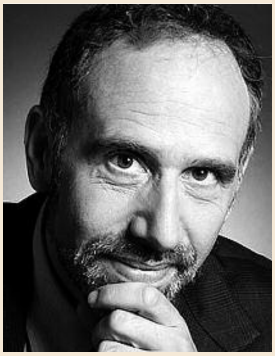
- Fourth, the achievement of a high degree of cross-border consistency in emerging regulations, laws, and standards that comprise the core elements of the post-crisis reform agenda.

Progress is being made in all of these areas, especially the Basel capital and liquidity standards. However, considerable further time and effort will be needed to round out the design and ultimate execution of these priority building blocks with particular focus on the challenges associated with enhanced resolution authority as it applies to systemically important financial institutions having an international footprint. Indeed, the design and execution of enhanced resolution authority is, by far, the most demanding and complex of the priority building blocks.

Having said that, I must acknowledge that the progress made over the past two years in this area has exceeded my expectations. Of particular note in this regard has been the cooperative efforts in the United States and the United Kingdom between the Federal Deposit Insurance Corporation, the Federal Reserve, and the Bank of England in a setting in which regulators and practitioners are learning from each other as to how best cope with the dozens of highly complex issues associated with the execution of enhanced resolution authority.

The four priority building blocks cited above are necessary—but by no means sufficient—conditions for enhanced financial stability. Several obstacles stand in the way of crossing the bridge from necessity to sufficiency. For example, final standards regarding the Volcker Rule and Single Counterparty Credit Limits among systemically important financial institutions have yet to be adopted. Beyond that, it remains very difficult (to put it mildly) for policymakers and practitioners to fully grasp the cumulative impact of the many interconnected elements of the reform agenda, including their potential implications for market liquidity.

All of this begs a much larger, and much more important, question, namely: Is today's system of financial intermediation safer and sounder than it was in the years leading to the crisis? My answer to that question is "yes." Having said that, it would be premature to declare victory, especially since the economic recovery remains fragile amid continuing uncertainties as to how fiscal and monetary policies in the United States will play out over the next several years. Nevertheless, I am confident that we can further ratchet up the standard of financial stability, thereby further reducing the probabilities of major financial shocks and the damage caused by such events.



It's up to the Fed.

DEAN BAKER
Co-Director, Center for Economic and Policy Research

Most of the discussion of the risk of a new financial crisis overlooks the most basic point about the last crisis: it was the result of an asset bubble. The crisis was not merely the result of irresponsible mortgage issuance and highly leveraged financial institutions, it also depended on the value of the underlying asset—housing—becoming sharply out of line with the fundamentals of the market.

This point is essential, because the last financial crisis was not only the result of failed regulatory policy, but also the failure of the Federal Reserve Board to take note of an unprecedented run-up in house prices. If the Fed had taken steps to counter the run-up in house prices, then the failed regulatory policy could not have led to a financial crisis.

The financial reforms in Dodd-Frank provide little basis for believing the regulatory structure has been sufficiently strengthened to prevent the sort of crisis we saw in 2008. The large banks are even larger as a result of the merger wave connected with the crisis. While the Volcker Rule is not yet finalized, it is likely the large banks will have little trouble gaming it.

The Dodd-Frank rules on mortgage-backed securities pose little restriction on the quality of mortgages that can go into pools. And the gutting of the Franken Amendment means the incentive for bond rating agencies to give investment-grade ratings to the banks paying for the ratings is exactly the same as it was before the crisis.

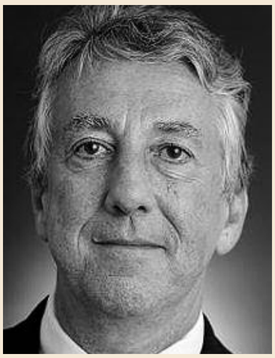
For these reasons, there is little basis for thinking improvements in the regulatory structure will prevent another financial crisis. However, there is reason to believe that the presence of intelligent life at the Fed can stop the sort of run-up in asset prices we saw during the housing bubble.

After a century in which nationwide house prices had on average just tracked the overall rate of inflation, real house prices rose by more than 70 percent in the years 1996 to 2006. It is astounding that this run-up in house prices escaped the attention of the Fed. It was also easy to see that it was not driven by the fundamentals of the market. Certainly income and population growth in this period would not have warranted any extraordinary increase in demand. And the near-record pace of construction indicated that supply constrains were not a serious problem.

Furthermore, there was no notable increase in rents. And, as early as 2002, vacancy rates were already at extraordinarily high levels.

The Fed had all the warning of a bubble it could have possibly asked for. In these circumstances it should have used its regulatory authority to do everything imaginable to curtail the explosion of low-quality mortgages. It also should have explicitly warned actors in the housing market of the existence of a bubble and of its intention to take steps to actively counter the run-up in prices. (This is a different type of forward guidance.) If these measures still were not sufficient to rein in house prices, the Fed should have been prepared to raise interest rates as much as necessary.

The reference to the failure of the Fed is central to any story of the financial crisis. It is desirable to have sound regulatory policies to prevent the sort of abuses that fueled the last bubble. However, if the Fed is awake, it will notice the growth of an $8 trillion bubble and take the steps necessary to prevent a bubble from growing large enough to jeopardize the health of the economy.



The short term appears safe. The long-term fault lines are rampant.

ROBERT JOHNSON

Executive Director, Institute for New Economic Thinking, and Former Managing Director, Soros Funds Management

I do not believe we are on the cusp of another financial meltdown in the near term. My view has little to do with appropriate regulatory architecture or strengths or weaknesses of Dodd-Frank, which I think is very weak legislation in light of the magnitude of the crisis of 2008. I believe the top management of the large complex financial institutions are themselves cautious after being burned by the mess they made that culminated in the crisis of 2008. The unbridled hubris of wild speculation is nowhere in sight with regard to risk in markets at present. I also believe there is considerable uncertainty regarding the willingness of Congress in the United States to go back to the well for another bailout. The anger at government that was spawned by "paying the polluters" with bailouts and bonuses is still fresh in the collective mind. Top management does not want to tempt fate and stick their neck in that angry lion's jaw so soon, hence their prudence and caution.

But self-restraint and caution at the helm of financial institutions will dissolve in time as memory fades. We plainly do not have a sound and clear financial regulatory and market structure. Before Dodd-Frank, the society at large bore too much of the downside risk for the financial sector. That is still true. Financial institutions dominated the Dodd-Frank legislative design. They poured a flood of money into lobbying, campaign donations, and rule-making forums. Similar processes of flexing the muscles of financial sector power in politics were evident in London and continental Europe. The unnecessarily risky "dark" markets of over-the-counter derivatives continue to fuel proprietary trading profits through front-running as the large market makers see the flows. OTC derivatives do not offer credible pricing of assets, and therefore capital (which is measured as a residual from asset values) cannot inspire confidence in the integrity and resilience of these firms. The broad social guarantees society provides to this system are not based on any sound reasoning. Society at large is resentful of being used by the financial sector. As Andrew Haldane of the Bank of England has described in his paper "Banking on the State," it puts us all at risk to support this hazard-prone speculative system that need not be connected to the payments system. The social contract between finance and society is way, way out of balance.

Those who believe that the separation of speculative activities from those banking activities providing payments services will jeopardize liquidity are subscribing to a myth. Liquidity and price discovery are the metaphorical talismans used to market the services of a financial industry that is at a loss to explain its value to society. The people who need very liquid markets are those who will churn portfolios rapidly, the financial institutions themselves. Is there really such a positive benefit for the rest of us that it warrants bearing the risks of underwriting the risk taking of these behemoth firms? How much liquidity is enough? How much subsidy of reckless behavior is needed to insure this magical liquidity will not vanish? Markets of the current structure certainly dried up in 2008, so it is hard to say that the current pre-Volcker Rule system gave this all-magical elixir to the world in return for such broad-based guarantees at that time. After all, it is in crisis that one may want to get out of positions quickly.

How does linking proprietary trading to the safety net help society as distinct from creating one-sided bets for the proprietary trading profit and loss of the financial institutions themselves? These questions are rarely asked when the legislature needs campaign contributions to survive.

As Mancur Olson described in his book *The Logic of Collective Action,* narrow interests will overwhelm the common good. This is not just rent extraction. The danger here is that the financial sector is, in the long run, able to do great harm to us all. While the short term appears safe, the longer-term fault lines of the too-big-to-fail banks and the conflicts of interest within bank holding companies are still rampant. OTC derivatives markets are privately profitable and subsidized by the access to the central bank's discount window. And most broken of all is the politics of repair.

There is likely another bubble out there, but we've got the means to prevent it.

JARED BERNSTEIN

Senior Fellow, Center on Budget and Policy Priorities, and former Chief Economic Adviser to Vice President Biden

I'm not sure either option reflects my views on the current status of financial regulation. The question as I see it is: What is the likelihood of another financial bubble, and have any of the reform efforts reduced that probability? And if so, have they done so at the expense of liquidity and market functionality?

History suggests it would be extremely foolish to say we're done with bubbles. As for Dodd-Frank, former Federal Reserve Vice Chair Alan Blinder recently wrote "…even this good-though-weak law now seems to be withering on the regulatory vine. Far from being tamed, the financial beast has gotten its mojo back—and is winning. The people have forgotten—and are losing."

So does this mean we sit back and watch the next bubble inflate?

Of course not. First, the horribly damaging housing bubble had many parents, but a big group of them were asleep-at-the-switch regulators, from the Federal Reserve to the (too many) smaller agencies whose job it is to oversee financial markets. Frankly [sic], they don't need a perfectly implemented Dodd-Frank to do their job.

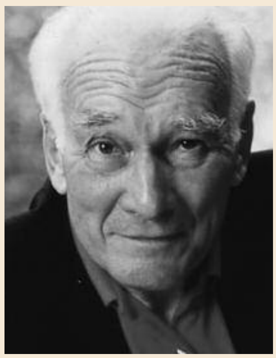
The Fed already has the power to spot and dampen bubbles, and the new Consumer Financial Protection Bureau, created by Dodd-Frank, can also play a key role, particularly in identifying dangerous consumer "innovations," such as interest-only adjustable-rate mortgages, or noting when risk is systematically underpriced by shoddy underwriting.

Still, one shouldn't be too pessimistic as to how the regulations will ultimately play out. We won't know how the so-called "resolution authority"—how regulators "resolve" a systemically connected, failed institution—will work until it's tested. The Volcker Rule, to prevent proprietary trading by institutions with insured deposits, is not yet in place. That's worrisome, because the way such things work in the Washington regulatory game, the longer they hang out there, the more they're gutted.

Higher capital reserves as a buffer against excessive leverage are a very important part of the solution, and they're still under discussion. Here, however, Blinder is right on point: lobbyists for the banks are fighting tooth and nail against rules insisting on adequate reserves since it crimps their profitability.

So sure, there's very possibly another financial bubble out there somewhere but we've already got the means to prevent it. It's a matter of willpower, shunning the lobbyists, and forthright, non-ideological analysis.

As for market functionality, this is the large, outstanding problem. Financial markets are simply not playing their critical function of allocator of excess savings to the most productive sources. This is a structural problem with profound implications for growth. Its solution goes well beyond the types of reforms we're contemplating.



The banks own the political system, so crisis is still a political risk.

MARTIN MAYER

Author,* The Fed: The Inside Story of How World's Most Powerful Financial Institution Drives Markets *(2002) and* The Bankers: The Next Generation *(1997)

The classic banker, who made loans to borrowers on their demonstration of a profitable use for the money, funding those loans in part from his own capital, was concerned first of all about how he would be repaid. The "investment banker" is concerned first of all about the price at which he can sell the paper he has created, leaving the question of who will receive the borrower's repayment for subsequent lenders to answer. These attitudes are incompatible. By offering the lenders a chance to take here and now the profits that will in fact be earned only over time, the securities-oriented banker creates instability, which even a central bank may find hard to control, especially in situations where collateral is losing value and the preference for cash can cascade.

What is essential is that central banks control the funding of the banking system and prevent the confusion of gambling instruments with insurance products. The Volcker Rule skirts the issue, but at least it does something. Coupled with enforcement of leverage limits and the absorption of quantitative easing, it could begin the process of shrinking the giant banks now so obviously too big to fail. Given the extent to which the big banks own the political system, the odds are bad that anything can be done until after the next crisis, but it's worth keeping the issue alive.

We are not out of the woods.

WILLIAM R. WHITE

Chairman, Economic Development and Review Committee, OECD, and former Head of Monetary and Economic Department, Bank for International Settlements

There is a significant risk of future economic and financial turmoil. The global economy is an almost seamless web of interconnectedness, both in the real and financial sectors. The fact that each individual geographical region exhibits serious fault lines adds further to the anxiety. But, if and when these problems materialize, they should not be thought of as a "second" great crisis. Rather, they would be a simple extension of the current one. Nor should our actual and potential troubles be labeled "financial." This implies that weakness in the financial sector was the root of the problem, and that better regulation could have avoided it. This is not true. The continuing global crisis has its real roots in monetary excesses going back two decades or even more.

The potential for future turmoil has been exacerbated by two developments. The first has been the failure to resolve the problems of over-indebtedness and excessive leverage revealed by the crisis. Second, closely related, ultra-easy monetary policy has essentially been "more of the same" stimulus that led to the crisis in the first place. In addition to impeding deleveraging, such policies have contributed to unsustainable increases in asset prices, risk-on-risk-off behavior, and increasingly volatile capital flows into emerging markets. None of these developments raises hopes for a future free of crises.

Some solace might be found in the introduction of new, international regulatory standards to prevent a recurrence of these past events. Broadly speaking, these measures are welcome. Banks generally have higher capital levels and are paying more attention to potential liquidity problems. The focus on the systemic properties of the financial system, and the identified need to avoid "procyclical" behavior, also seem highly welcome. Nevertheless, grounds remain to question the sufficiency of the crisis prevention measures taken to date.

First, measures taken to manage the current crisis have made the prevention of future crises more difficult. The "too big to fail" problem has become worse and moral hazard has been exacerbated. Second, an active debate indicates that the analytical foundations of the new proposals remain highly contestable. For example, while bank capital requirements are higher, are they high enough? Third, implementation of the new proposals could suffer from different practices across regions leading to regulatory arbitrage and a loss of credibility. Fourth, the financial industry will lobby and innovate in an attempt to circumvent new regulations. Finally, we must confront the law of unintended consequences. In complex, adaptive systems, things rarely work out exactly as anticipated. In particular, the "plumbing" of the financial system needs more attention. We are not out of the woods yet.

Regulator overreaction is indirectly leading to increased risk.

ALEX J. POLLOCK

Resident Fellow, American Enterprise Institute, and former President and CEO, Federal Home Loan Bank of Chicago

First of all, the question posed, "Is regulation, or the lack thereof, risking a second great financial crisis?" needs to be corrected. Crises are quite frequent in financial history—they occur about once every ten years on average, according to the great economic historian Charles Kindleberger. Or as Paul Volcker said, "About every ten years we have the biggest crisis in fifty years." So the appropriate question is whether regulation is risking "yet another," not a "second," financial crisis. The answer is that oppressive regulation is indeed increasing this risk, but indirectly, through its effects on central bank financial manipulation.

An utterly predictable part of financial cycles is that following each crisis, there will be a political and regulatory overreaction. Congress always feels the political compulsion to Do Something—so it does. Also entirely predictable is that the new multiplication of rules and regulatory bodies will be accompanied by confident predictions that "Now this can never happen again." Such pronouncements go back at least to the creation of the Federal Reserve in 1913. But the crises always happen again anyway.

In the aftermath of the Great Housing Bubble of 1999–2006, and the crisis of 2007–2009, the typical political cycle repeated once again. An onerous and very expensive new regulatory inflation was launched and still continues expanding. The new regulations have made mortgage lending, in particular, much more difficult and costly and created a lot more regulatory and legal risk for lenders. Surprise! This constrained mortgage lending and made it much more difficult for many people to obtain mortgage loans. Moreover, the costs of this regulation are disproportionately high for smaller banks.

Enter the Federal Reserve, which wanted and wants to expand the mortgage lending which the onerous regulation has constrained, in order to try once again (as it did in 2001–2004) to promote higher house prices and thereby a "wealth effect." This time that goal meant reducing long-term interest rates to far below their market-clearing levels, which led the Fed to its remarkable bond market and mortgage market manipulation. As is well known, the Fed now owns more than $2 trillion of long-term government bonds, and more than $1.3 trillion of government-sponsored mortgage-backed securities.

What will the future effects of this massive manipulation be? Nobody knows, including the Fed itself. It has certainly crushed savers and resulted in many parties reaching for yield. In all probability, it has dramatically increased the interest rate risk of the entire financial system. (This includes the Fed's own balance sheet, which has a level of interest rate risk which the Fed would pronounce unsafe and unsound in any other bank.) In this fashion, the typical regulatory overreaction is indirectly leading to increased risk of yet another financial crisis.

Regulation did not address the fundamental cause of the crisis.

PETER J. WALLISON
Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute

The question of whether the Dodd-Frank Act is good or bad is easily resolved once it becomes clear that it did not address the causes of the financial crisis. Unnecessary regulation can't be good.

By June 2008, before the financial crisis began in earnest, there were more than thirty-two million subprime and otherwise weak mortgages in the U.S. financial system, about 58 percent of the fifty-five million American mortgages then outstanding. Of this thirty-two million, 75 percent were on the books of U.S. government agencies, principally Fannie Mae and Freddie Mac. This was the result of a set of policies adopted by Congress in 1992, which required Fannie and Freddie, when they bought loans from banks and other originators, to meet a quota of loans that had been made to borrowers at or below the median income in their communities. Between 1992 and 2008, the U.S. Department of Housing and Urban Development increased this quota seven times, from 30 percent in 1992 to 50 percent in 2000 and 56 percent in 2008.

Because it was difficult for Fannie and Freddie to find prime loans among borrowers below the median income, they had to reduce their underwriting standards over this period, accounting for the large number of subprime loans on their books in 2008. Fannie and Freddie were the key players in the U.S. housing market, setting the standards for their suppliers—the lenders—in the primary market. For this reason, their underwriting standards, initially intended for low-income borrowers, spread to the wider market. After all, who wouldn't want a 3 percent or a zero downpayment if it was on offer?

The large sums that Fannie and Freddie were pouring into the housing market over a sixteen-year period, and the leverage their low credit and collateral standards produced, built the largest housing bubble in U.S. history. By 2007, when it began to flatten out, it was about nine times larger than any previous bubble. The sharply rising housing prices in the United States, and the high yields on subprime mortgages, attracted investors in the United States and around the world, most apparently believing that "this time it's different."

When the bubble finally collapsed, it generated unprecedented numbers of mortgage defaults. Investors fled the market for mortgage-backed securities, and mark-to-market accounting required the financial firms that were holding these instruments to write them down, making these firms look unstable or insolvent. When Lehman was allowed to go bankrupt, a full-scale panic ensued.

The Dodd-Frank Act is probably responsible for the weak recovery we have had thus far. The fact that it didn't address at all the true causes of the crisis just makes it that much worse.

The first great financial crisis has not ended.

JAMES K. GALBRAITH

Lloyd M. Bentsen, Jr., Chair in Government/Business Relations and Professor of Government, Lyndon B. Johnson School of Public Affairs, University of Texas at Austin, and author, **The End of Normal: Why the Growth Economy Isn't Coming Back and What to Do When It Doesn't** *(forthcoming, 2014)*

Often when it is said that there are two views on an issue, the effect (if not the intent) is to conceal a third option. In this case, my view holds that the first great financial crisis has not ended. Banks are profitable and their executives are at liberty. Neither suffices to declare the crisis over.

A better test would be a confident return to business lending and job creation with meticulous loan underwriting under good supervision. Don't hold your breath.

Without that, the crisis goes on. It consists in powerful lobbies gumming up the implementation of weak reforms, which were enacted by craven politicians mainly for show. Meanwhile, the taint of unpunished crimes hangs over banks and bankers. Need one mention the failure to prosecute a single officer of HSBC for laundering Mexican drug money? Or the impunity of Bank of America and Countrywide, the merely civil pursuit of JPMorgan Chase over the London Whale, of Goldman Sachs over the Paulson Short? With grace freely offered for crime, why would an independent investor trust today's bankers, whether they are or are not, in any particular case, honest and ethical? And it's obvious that they don't, otherwise the world would not be awash in cash.

If there is a second meltdown, it probably will not come from some new panic over the sudden discovery of toxic assets. It will come from a political revolt against the retrenchment, austerity, and social destruction to which the crisis has led. That revolt probably will not originate in the United States. But it might come in Spain, Portugal, Ireland, Italy—or Greece. Especially from Greece.

And it would not be a minute too soon.

Forget the regulatory issue. The worry is excessive central bank liquidity.

DINO KOS

Executive Vice President, CLS Bank International, and former Executive Vice President, Markets Group, Federal Reserve Bank of New York

Neither view is correct. Dodd-Frank is not finished—and certainly has its flaws—but it is false to assert the banks are either unregulated or less regulated now relative to pre-crisis. Basel III, new liquidity requirements, European Market Infrastructure Regulation, and recovery and resolution plans are only a sample of new and tighter regulations that are or will soon be in effect. Leverage ratios for banks are on the way, as are activity restrictions driven by the Volcker Rule, ring-fencing of retail banking in the United Kingdom, and similar rules elsewhere. Outside the banking sector, more work needs to be done reforming money market funds, tri-party repo, and other parts of the shadow banking system. Nevertheless, the financial system as a whole is more tightly regulated and enforcement is more stringent, as demonstrated by regulators' new-found willingness to demand admissions of wrongdoing when settling cases.

Has the pendulum swung too far such that tougher regulations are holding back economic activity? Here too the answer is no. Banks have tightened credit standards and are more diligent about assuring the paperwork is correct. This has slowed down the mortgage application process, but not so much as to forestall the housing recovery. In any case, do we really want to go back to the days of instant approval without doing basic due diligence? Credit in other sectors has recovered. Commercial and industrial lending bottomed out in mid-2010 and has been growing since. Banks have the capacity and incentive to lend. What is missing is stronger demand. But weak demand is about the inevitable adjustment and deleveraging from bubble-era levels, not excessive regulatory zeal.

The question posed is about the risks of a second financial crisis. Looking to regulations at this juncture is to look in the wrong place. Instead, we should worry about the long-term effects of massive and ongoing injections of central bank liquidity and deliberate attempts to upwardly manipulate asset prices that will, at some point, need to be reversed. Such a reversal has never been observed and the risks of getting it wrong are not trivial. Nothing the regulators are doing (or likely to do) will pose such risks to the financial system.

The mispricing of risk is back.

CATHERINE L. MANN

Barbara '54 and Richard M. Rosenberg Professor of Global Finance and Director, Rosenberg Institute of Global Finance, International Business School, Brandeis University

The fundamental causes of the last financial crisis were liquidity, leverage, and the mis-pricing of risk. Liquidity, as interest rates were kept low for too long. Leverage, as financial intermediaries were able to use triple-A collateral as backstop to augment exposures and profits. Mis-pricing of risk, as lack of transparency about borrowers' credit interacted with an incomplete assessment of the risk inherent in complex financial instruments (including by those who gave these instruments triple-A ratings).

At this juncture, there is plenty of liquidity, and leverage is back on the rise. However, the mis-pricing of risk, in 2008 and now, is the fulcrum for crisis. Why? Even if the complexity of instruments and the credit characteristics of the obligors are fully priced in, the pricing of risk would still be incomplete because of network externalities. More importantly, no assessment of individual risks of an instrument or borrower will ever fully price in the potential for network contagion—because this is a classic case of private cost/benefit differing from social cost/benefit.

So the real question is whether the gap between private and social costs/benefits is narrowing or widening. How much has the network externality been internalized into individual decisions and into the pricing of risk? After having been illuminated by the financial crises, and with actors chastened, this externality is back on the rise.

The Volcker Rule has the potential for unintended consequences.

RANDALL S. KROSZNER

Norman R. Bobins Professor of Economics, University of Chicago Booth School of Business, former Governor, Federal Reserve System, and co-author,* Reforming U.S. Financial Markets *(MIT Press, 2011) with Robert Shiller

As in the 1930s, restrictions on bank activities play an important role in the current regulatory response to the financial crisis. The Volcker Rule strictly limits commercial bank activities in proprietary trading, private equity, and hedge funds. The prohibitions on private equity and hedge funds have not created much controversy because these activities are relatively easy to define and had not become an important part of commercial bank operations.

Propriety trading, however, involves fundamental challenges to define and to regulate. The notice of proposed rulemaking from the U.S. regulatory agencies ran more than two hundred pages and asked for comments on 383 questions! The notice was issued two years ago and, as of this writing, the final rule is still not complete. The Dodd-Frank Act provided little concrete guidance on where to draw the line and, hence, the lengthy list of questions and the long struggle to publish a final rule.

The Volcker Rule has the potential for unintended consequences such as increasing riskiness of banks and markets, depending upon how "proprietary" is defined and the rule is implemented. Hedging activities of banks, for example, could be curtailed if the net is cast too widely. In addition, the role that banks play as market makers in key global markets, such as those for corporate bonds and non-U.S. government securities, could be reduced or eliminated. The unintended consequence could be to reduce liquidity, widen bid-ask spreads, and increase volatility. A number of international regulators, in addition to many banks, have raised the concern that the Volcker Rule could make important markets less stable.

There is little, if any, systematic evidence that proprietary trading increased the risk of failure of commercial banks in the recent crisis (or the 1930s). In the United States, the major depository institutions that failed did so primarily due to poorly underwritten mortgages, not proprietary trading. Across the globe, universal banks did not fare worse than their more "narrow" counterparts and in many cases benefitted from the diversification of income sources associated with engagement in a wide variety of activities.

As we have learned from earlier episodes of regulatory arbitrage, restrictions that apply to one set of institutions may just move risks to other institutions or markets and, at the same time, increase inter-linkages and market opaqueness. Pushing risk-taking activities into the "shadows" just outside of the commercial banking system could have the unintended consequence of making the entire system more, rather than less, fragile and more difficult to regulate.

The likely extensive compliance requirements of the Volcker Rule will direct substantial supervisory resources to checking boxes and distract supervisors from focusing on the actual risk exposures of the banks and of the system, regardless of whether the activities comply with a particular rule or not. Banks would have incentives to innovate products or procedures that would comply with the letter of the rule but could involve substantial risks.

Making markets and banks more, not less, robust is crucial for the stability of the financial system, and this goal often seems lost in the debate over activity restrictions on banks.