Sheila Bair goes on the attack again

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By Robert Teitelman
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Wouldn't you want to be at Treasury Tuesday when Treasury Secretary Tim Geithner reads The New York Times? There, at the top of the op-ed page, Sheila Bair, head of the Federal Deposit Insurance Corp., continues to wage war against the Treasury's plan for a super-regulator (that's the Federal Reserve if you've been on vacation), despite Geithner's failed efforts to pummel her and a number of her regulatory minions into line. There's a lot to ponder and speculate about the underlying politics of all this. Did Bair launch another attack -- geeze, it's not as if she hasn't had a lot of opportunity to vent -- because the White House has tapped Fed Chairman Ben Bernanke, who's still grumbling about the consumer products watchdog, for a second term? Or is this part of an orchestrated campaign, with its releases over the last few days about how many banks are now on the watch list, to convince politicians and the public about the essential importance of the FDIC?

Blair's argument hasn't changed. A super-regulator will be dangerous and more prone to capture and mistakes than a multipolar collection of regulators meeting regularly as a council. This is the "more-heads-is-better-than-one" argument. "One advantage of our multiple regulatory system it that it permits diverse viewpoints," she writes, eliciting the reaction: How much worse would it have been if there were fewer viewpoints? In fact, we seemed to have ended up with multiple perspectives that produced one viewpoint anyway. Besides, a committee or council that can't come to a consensus is dysfunctional, which makes it vulnerable to capture by a single viewpoint. Bair does not mention those nuances.

However, Bair does admit that traditional fragmentation led to regulatory arbitrage, which led to the bank crisis. "The principal enablers of our current difficulties were institutions that took on enormous risks by exploiting regulatory gaps between banks and the non-bank shadow financial system." Her answer seems to be a very simplistic structural solution. We need to plug the gaps, but leave the system essentially as it is. After all, she says, a single regulator would "endanger a thriving, 150-year-old banking system that has separate charters for state and federal banks." (Separate charters, yes, but the FDIC gets to regulate both.)

There's an entire essay packed in that sentence, but for now let's just focus on that 150 years. Well, not all 150 years were as swell as Bair makes them out to be. In 1932 the entire banking system, from little banks to big banks, from community banks to industrial lenders, collapsed in a heap and had to be revived by the federal government (in part by creating deposit insurance and the FDIC). In the '80s, an entire swath of local banks went down in flames again: the now-defunct savings & loans. And of course last year, we had a crisis that reminded folks of 1932. So it's not exactly 150 years of sheer glory.

Given all that, the most egregious statement in Bair's op-ed is her insistence that "this is not about protecting turf." Well, it is, almost by definition. Protecting turf may be good policy or bad policy. But to deny that a government regulator "is not protecting turf" is almost the greatest evidence that she is, in spades.

The fact is that Bair's not all wrong. There are serious problems with the notion of the Fed as a super-regulator. The Fed hasn't proved in the past to be a particularly strong bank regulator. It has tended to favor large banks and bank consolidation and the efficiency and competitiveness arguments over the safety and prudence of an industry of smaller banks. It has a big problem with too-big-to-fail. Over its history, the Fed, for all its expertise and tradition, has been prone to regulatory capture. And it threatens to shed its monetary autonomy as it reaches for greater regulatory powers.

But as Judge Richard Posner argues in a detailed critique of the Treasury reform plan (you can find the two-part piece at the Harvard Law School Forum on Corporate Governance and Financial Regulation), the reform schemes that have been put forward by Treasury are undercut by the simplistic explanations for the cause of the crisis in the first place. Somehow regulators or politicians had no role in the crisis, which was caused mostly by, well, greedy bankers and greedy dumb consumers:

The Report asserts without evidence or references that the near collapse of the banking industry last September was due to a combination of folly -- a kind of collective madness -- on the part of bankers (in part reflected by their compensation practices), of credit-rating agencies, and of consumers (duped into taking on debt, particularly mortgage debt, which they could not afford) and to defects in regulatory structure. This leaves out many potential causes that other students of the crisis have emphasized.

Posner urges a greater study of the crisis like a new 9/11 commission and, echoing Paul Volcker from a number of months ago, more thought and time before reforms are passed. The notion of such a "neutral" commission is worth a posting on another day, but suffice to say, Bair, in her op-ed, is completely accepting of the Treasury explanation -- particularly in its emphasis on evolutionary "structural" issues, not on deregulation or regulatory capture -- with the twist that the fault really seems to lie with a few big banks (Fed regulated, of course) and not poor community banks; in this strand of her argument, Bair is taking up a big-little, city-rural, federal-state tension that has existed in American banking since the bank charter system came into existence, and perhaps before. And yet, much of the mania that beset the big banks, particularly when it came to real estate, also afflicted smaller, local banks. They were simply not as highly leveraged and not as exposed to the markets as the big boys. But they are clearly suffering in large numbers now and the FDIC watch list is bulging.

All this is hardly a comfort for ordinary Americans. There is a general sense that the regulatory system needs to be fixed and that financial disasters need to be averted. That may be impossible; regulatory capture, bubble mitigation and the innovation issue are three very difficult tendencies to control. But long before the crisis broke, there was a general consensus throughout banking that the system needed to be rationalized, that obvious gaps needed to be plugged and that the system was both replete with blind spots and, in large areas, redundant, cumbersome, inefficient and needlessly expensive. But as the reform process has struggled along, few of those fundamental weaknesses seem certain to be rectified. I'm as happy to see lively, hair-pulling debate as the next guy (though whether Geithner would want the feisty Bair on his reg council is another matter). But the sight of regulators -- not politicians, technocrats -- continuing to bicker

this far into the process is very discouraging and perhaps an argument all by itself of a need for a stronger center. Or maybe Posner's right and we should shelf the damn thing and take a breather.
- Robert Teitelman

Also see:
The Case Against a Super-Regulator
A critique of the President's financial regulation reforms

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