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Alan Greenspan, Regulator?

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Alan Greenspan made his own case for significant financial services regulation yesterday adding to the growing momentum for important legislative reform. But, you would hardly know it from reading the newspapers.

Testifying before the congressionally created Financial Crisis Inquiry Commission, Greenspan removed his libertarian cloak and spent a significant portion of his [testimony](#) in new regulatory garb arguing:

- Poor private sector decision-making, especially poor private sector risk management and creation of incomprehensible financial products, lead to the credit crisis.
- Even with the breakdown of private risk management and the collapse of private counterparty credit surveillance, "the financial system would have held together had the second bulwark against crisis -- our regulatory system -- functioned effectively. But, under crisis pressure, it too failed."
- Structural regulation is critical because regulators "who are required to forecast have had a woeful record of chronic failure. History tells us they cannot identify the timing of a crisis, or anticipate exactly where it will be located or how large the losses and spillovers will be."
- To deal with "inherently unforeseeable shocks, there are two primary regulatory imperatives: (1) increased risk-based capital and liquidity requirements on banks and (2) significant increases in collateral requirements for globally traded financial products, irrespective of the financial institutions making the trades." With adequate capital, debtors will be repaid and contagion avoided. "All losses accrue to common shareholders."
- Moreover, firms simply cannot be allowed to become "too big too fail," taking excessive risk because of the need for government to save the individual company to save the financial system. Greenspan proposes special contingent capital bonds which convert to equity in an emergency and creation of a special bankruptcy facility for orderly liquidation with statutorily defined "haircuts" for creditors.

- Enforcement against financial misrepresentation and fraud must be significantly increased.
- In sum, the next pending crisis will no doubt exhibit a plethora of new assets which have unintended toxic characteristics, which no one has heard of before, and which no one can forecast today. "But if capital and collateral are adequate...[t]ax payers will not be at risk. Financial institutions will no longer be capable of privatizing profit and socializing losses."

But, this testimony wasn't what the major papers reported. *The New York Times*: "Fed Reviews Find Errors in Oversight of Citigroup." *Wall Street Journal*: "Greenspan Grilled Over Role in the Financial Crisis." *The Financial Times*: "Greenspan Mauled Over Role in Meltdown." *The Washington Post*: "Greenspan Defends Decisions Before Panel Investigating Crisis."

The stories themselves featured sharp interchanges between panel members and Greenspan over the Fed's past role. Conflict will always prevail over consensus in the daily news cycle. But Greenspan's points are *some* of the fundamental concepts which reformers have been advancing for more than a year since the financial crisis broke down upon us (but *hardly all*, for example, regulatory assessment of systemic risk). Organizational authority and actual implementation are critical -- issues Greenspan didn't (couldn't) address in a piece of testimony. But Greenspan's arrival at the regulatory party is one of the last pieces of a bipartisan consensus that significant regulatory reform to ensure the safety and soundness of the financial system is necessary -- and is likely to be enacted this year.

So, in many respects, this is the real news from his testimony. The commissioners on the Financial Crisis Inquiry Commission can develop their views -- and write their report. But, the irony is that its report isn't due until after the fall elections -- and after major financial services reform, which has been the subject of a year's debate already, has been voted up (or down).

This focus on conflict, and down-playing of general support for major financial reform, has also characterized recent coverage of two other major figures in the world of finance: Lloyd Blankfein of Goldman Sachs and Jamie Dimon of J.P. Morgan Chase.

Blankfein recently issued his [letter](#) to shareholders and news reports focused on an attempt to explain how Goldman had always acted in the interests of customers, and not traded against those interests. Yet in the letter, Blankfein said business was at fault and repeated his call for major regulatory reforms to ensure safety and soundness (while, of course, preserving room for creativity and innovation), a position developed in much more detail in his own [testimony](#) before the Financial Crisis Inquiry Commission. That testimony addressed the major issues of capital adequacy, leverage, size, transparency, and moral hazard which are central to the debate. But it was overshadowed in news reports by harsh commissioner questioning.

Similarly, the *Wall Street Journal* recently ran a [piece](#) on Dimon's opposition to some pieces of the financial reform packages. It gave only a sentence or two to a long section in Mr. Dimon's own recent [letter](#) to shareholders on the failure of the private sector and the need for regulatory reform, especially in the areas of systemic risk and resolution of large, failing financial institutions.

From one perspective, one can take with a pillar of salt the pronouncements of Messrs. Greenspan, Blankfein and Dimon in favor of reform. Each has his own self-interested agenda and broad principles about safety and soundness are not the same thing as meaningful details and effective implementation.

Yet, from another perspective, their views -- especially Greenspan's -- do show the power of the idea that private financial sector institutions were a primary cause of the meltdown (despite roles played by many other actors in causing the crisis) and that significant government regulation is needed. When we step back, this consensus is likely to lead to another major shift in government involvement in the economy (after health care).

On the same day, that it reported the conflict over Greenspan's testimony about the past role of the Federal Reserve, *The Financial Times* ran a story headlined "[U.S. Financial Reform Picking Up Momentum](#)." Hard issues -- such as appropriate consumer protections and methods for handling large, failing firms -- remain. But the call for major changes from all points on the political spectrum -- symbolized now by Greenspan, too -- suggest that compromises will be found and legislation passed: legislation, like health care reform, that will be far from perfect but will effect major change.

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