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Audit of the Conventional Wisdom

The Audit of Conventional Wisdom

In this series of essays, MIT's Center for International Studies tours the horizon of conventional wisdoms that define U.S. foreign policy, and put them to the test of data and history. By subjecting particularly well-accepted ideas to close scrutiny, our aim is to re-engage policy and opinion leaders on topics that are too easily passing such scrutiny. We hope that this will lead to further debate and inquiries, with a result we can all agree on: better foreign policies that lead to a more peaceful and prosperous world. Authors in this series are available to the press and policy community. Contact: Michelle Nhuch (NHUCH@MIT.EDU, 617.253.1965)

Center for International Studies
Massachusetts Institute of Technology
Building E38-200
292 Main Street
Cambridge, MA 02139

T: 617.253.8093
F: 617.253.9330
cis-info@mit.edu

web.mit.edu/cis/
web.mit.edu/cis/acw.html

The Global Financial Crisis and Obstacles to U.S. Leadership

David A. Singer

MIT Center for International Studies

We are in the midst of a global financial crisis. The U.S. “sub-prime” crisis, which triggered some of the largest bank failures in U.S. history, has now spread in earnest to Europe and Asia. Bank failures around the globe are likely to continue as housing markets collapse and credit markets run dry. There are signs that the crisis may get much worse: as of this writing, the U.S. Federal Deposit Insurance Corporation (FDIC) has identified more than 100 banks on its “troubled bank” list, and European regulators are faring poorly in their efforts to keep their own banks standing. In response, central banks have created *ad hoc* swap arrangements to ease international liquidity problems, and they have recently slashed interest rates in an unusual exercise of international coordination. The governments of the G-7 economies may in fact coordinate their fiscal policies as well, given the pressing need for a unified fiscal stimulus to counteract the pending global economic slowdown. But the important question for global governance is, will the financial crisis prompt a serious international effort to change the rules of domestic and global banking? Will the U.S. join forces with its financial peers not just to *respond* to the crisis, but to *prevent* such a meltdown from happening again?

Accountability of the Conventional Wisdom

David A. Singer is assistant professor of political science at the Massachusetts Institute of Technology. He is author, most recently, of *Regulating Capital: Setting Standards for the International Financial System*, published in 2007 by Cornell University Press.



I offer a fairly gloomy assessment of the prospects for a global regulatory response, despite the galvanizing effect that the financial crisis appears to be having on regulators and central bankers. There are two main reasons for this assessment: the myriad proximate and underlying causes of the crisis, and the considerable fragmentation of domestic financial regulation in the U.S. Without U.S. leadership, any modifications to the existing set of international standards for bank regulation will likely be cosmetic rather than substantive. On the other hand, the most significant regulatory response to the financial crisis may be within the U.S. rather than international: the U.S. Treasury's regulatory blueprint recommends the organizational consolidation of U.S. financial regulation, including the dismantling of the Office of Thrift Supervision and the creation of a federal insurance regulator. The consolidation of U.S. regulatory agencies might facilitate international regulatory cooperation in the long term simply by reducing the transaction costs of international negotiation and clarifying agency accountability.

Lessons from the Past

In the recent past, bank instability in the U.S. and the U.K. prompted both countries to press for new international financial regulation. A quick review of the 1980s may help to shed light on the prospects for a similar international regulatory response to the current financial crisis. In the U.S., bank failures increased dramatically throughout the 1980s, and regulators were quick to realize that their own lax regulations were the cause. When Continental Illinois collapsed in 1984, Congress did not hesitate to place blame on the Federal Reserve and (especially) the Office of the Comptroller of the Currency (OCC). In response, the two regulators imposed a new minimum capital cushion for banks in 1984-5. But obviously the regulators' actions had little effect on the tide of bank failures, as 468 commercial banks failed between 1985 and 1987—more than in the prior 30 years. By the mid-1980s, regulators felt extraordinary pressure to tighten regulations further. But as I have noted elsewhere, regulators also faced a rising competitive threat from Japanese banks, which faced less stringent capital rules.¹ The rise of the Japanese banking sector created an environment in which U.S. regulators were hard-pressed to maintain stability without harming bank profitability. It was precisely this environment that led U.S. regulators to press for an international standard on capital adequacy.

The U.K., coincidentally, was in a similar position in the 1980s. The U.K.'s financial instability began a bit earlier in the 1970s with the so-called secondary banking crisis. In 1979, largely as a result of the crisis, the Bank of England was finally granted the statutory authority to regulate and supervise the banking sector. Then in 1984, London-based Johnstone Matthey Bankers collapsed, triggering a strong regulatory response by the Bank of England. But the London banking sector, like the U.S., was aggressively fending off the incursion of Japanese banks (both in domestic markets and in international lending). By the late 1980s, regulators from the U.S. and the U.K. found themselves on the same side in advocating for a new international standard for capital adequacy. The result—the 1988 Basel Accord—would subsequently become the most prominent example of international financial regulation. In its second iteration, the Accord remains the backbone of bank regulation in all major markets around the world.

The Politics of Accountability

Will today's financial crisis lead down a similar path to international regulation? One reason for skepticism is the complicated politics of accountability within the U.S. regulatory system. The blame for the subprime crisis easily shifts from regulator to regulator, and from policymaker to policymaker. Members of Congress are quick to blame the bank regulators—specifically, the Federal Reserve (which oversees all member-banks of the Federal Reserve system), the Office of Thrift Supervision (OTS), and the OCC. The bank regulators, however, can deftly shift

part of the blame to capital markets regulators and credit agencies. In recent testimony to Congress, OCC head John Dugan unabashedly blamed credit agencies for giving banks a false sense of confidence in the security of “super-senior” tranches of collateralized debt obligations. He also noted that “nonbanks” were responsible for originating 90 percent of subprime mortgages in 2006.² More generally, bank regulators can blame the process of securitization—which traditionally falls under the jurisdiction of the Securities and Exchange Commission (SEC)—for disrupting the prudential management of banks’ lending portfolios. Finally, all U.S. regulators can point to the structural causes of the crisis: the massive influx of foreign capital required to make up for persistent annual government budget shortfalls, and a prolonged period of abundant liquidity that led to a disastrous real-estate bubble.³

I have no interest in adjudicating these claims; rather, I highlight them to emphasize the difficulty that policymakers face in attributing blame for the crisis. Political pressure from Congress must be direct and unambiguous to kick regulators onto the international stage. Such pressure has not yet been manifest in the current crisis, and the fragmentation of domestic accountability will help to shield bank regulators from the scorn they endured during the 1980s crisis. Indeed, regulators appear to be muddling through the crisis as if they were responding to an exogenous act of nature, rather than cleaning up a mess that they may have caused.

Regulatory Fragmentation and the U.S. Response

The U.S. has one of the most institutionally fragmented financial regulatory environments of any industrialized country. Banks face an alphabet soup of regulators, including the Fed, the OCC, OTS, FDIC, the National Credit Union Administration, and separate state regulators, while the SEC, the Commodity Futures Trading Commission and other regulators monitor the capital markets. Most surprisingly, the U.S. does not have a federal insurance regulator; instead, 50 separate state regulators govern insurance firms within their jurisdictions. In the 1980s, when bank capital adequacy was unambiguously too low, the Fed, OCC, and FDIC combined forces in tightening capital adequacy requirements, and the Fed represented the group in the negotiations over the Basel Accord. The response to the current financial crisis will likely be much less coherent. For the reasons

described above, there is no clear smoking gun; culpability is spread far and wide; and the welter of regulatory agencies does not bode well for a unified national stance in any international negotiation.

The regulatory environment in the U.S., however, is likely to change. The Treasury’s blueprint calls for the dismantling of OTS, the enhancement of the Fed’s supervisory authority, and the creation of a national insurance regulator to replace the 50 separate regulators. Regulatory consolidation in the U.S. might be the most important catalyst for the creation of new international regulatory standards in banking. Consider the immense challenges of creating a global standard—which most likely cannot occur without U.S. support—when the agencies *within* the U.S. are at odds with one another! Ironically, U.S. investment banks

themselves may have cleared one obstacle to international cooperation: the remaining free-standing securities firms (Goldman Sachs and Morgan Stanley) have opted to transform themselves into bank holding companies. This move reduces the SEC’s influence and gives the Fed a more uniform role in supervising financial institutions. Nevertheless, there is still considerable fragmentation in the regulation of a range of activities that clearly have an important bearing on the stability of the banking system. If today’s financial crisis triggers the institutional consolidation of domestic financial regulation, then fruitful international negotiations will be more likely in the future. But until such consolidation occurs, the welter of U.S. regulatory agencies will face considerable obstacles in addressing the complicated inter-

actions between banking, disintermediation, and capital markets that are at the root of today’s financial crisis. And the fragmentation of accountability among regulators and policymakers will continue to hamper U.S. leadership in preventing such a terrible crisis from happening again.

“One reason for skepticism is the complicated politics of accountability within the U.S. regulatory system. The blame for the subprime crisis easily shifts from regulator to regulator, and from policymaker to policymaker.”

footnotes

¹ See David Andrew Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca: Cornell University Press, 2007) and “Capital Rules: The Domestic Politics of International Regulatory Harmonization,” *International Organization* 58, 3 (2004): 531-565.

² Testimony of John Dugan before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 4, 2008.

³ For a discussion of other fundamental causes of the crisis, see Robert Wade, “The First World Debt Crisis of 2007-2010 in Global Perspective,” *Challenge* 51 (2008), 4:23-54.



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