

**The Economic Crisis - One Year Later  
Forum for the Future of Higher Education**

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**Financial Markets and Risks - Summary  
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Douglas Elliott, a Brookings Fellow in Economic Studies, was an investment banker for two decades prior to joining Brookings. He assesses the current state of the financial sector and outlines his expectations for financial regulatory reform. Elliott is optimistic about the passage of financial regulatory reform for a number of reasons, including the political risk of opposing reform when the public is passionate about the need for it. Key reforms include higher capital and liquidity requirements for banks, enhanced resolution authority in the case of failed non-banks, and establishment of a Consumer Financial Protection Agency and an overall systemic risk monitor. Elliott offers his views of how effective these reforms will be in practice.

Key observations include:

- ∞ Big banks have largely recovered from the financial crisis and are earning profits again. However, small and medium-sized banks, which invested heavily in commercial real estate, will continue to fail for quite a long time.
- ∞ The commercial real estate bubble was worse in percentage terms than the mortgage bubble. Smaller banks, on average, have roughly 40 percent of their loan portfolios in commercial real estate - compared to an average of 10 percent for the larger banks.
- ∞ At this point, it appears that the credit crunch is over for larger companies, but it persists for medium and small businesses because their traditional lenders are being hit the worst now.

∞ It is likely that comprehensive financial regulatory reform will be adopted for several reasons, including:

- Intense public dislike of bankers and, likewise, pressure for reform, making it politically risky to oppose reform and be seen as on the side of the bankers.
- The fact that currently, regulators could do a significant part of what is being proposed anyway – although they would prefer direction from Congress.
- The banking industry realizes that they may have overplayed their hand and continued intense lobbying against reform could backfire on them.
- The banking industry would benefit from simply having it done and clearing up the uncertainty, which is not good for them in the marketplace.

∞ Key components of financial regulatory reform include:

- Higher capital requirements and higher liquidity requirements for banks, including significantly higher requirements for the largest banks. The lending market will survive these higher requirements.
- Enhanced resolution authority for regulators to deal with large, systemically important non-banks. Powers similar to the FDIC's are crucial so that decisions can be made very quickly – and should allow the institution to emerge intact. However, a compromise has already been made in Sen. Dodd's financial reform bill to take the legalistic, bankruptcy approach favored by the Republicans, as opposed to resolution.
- Establishment of a Consumer Financial Protection Agency. The debate around this centers on the independence of the agency; at this point it seems that it will be set up inside the Federal Reserve, and likely will be weaker in the final legislation than in Sen. Dodd's proposal.
- Establishment of an overall, systemic risk monitor. While this is very worth doing, in practice it is hard to envision how much ability such a monitor will actually have to, for example, prevent bubbles.
- The Volcker Rule, an attempt to eliminate proprietary trading and hedge fund-type activities from within the banking system. How this could be put into practice is extremely problematic, and it is unlikely to happen even if the rule is adopted.