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

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Financial Markets and Risks
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Introduction

Barry Bosworth: This session is on the financial market situation and financial reform. We've heard that the recession is over, so now we can turn to trying to repair the damage.

And on the subject we have Doug Elliott here from Brookings to speak. Doug came to Brookings in January of last year, after the beginning of the crisis. So it's not quite that he's responsible for the whole thing.

MR. ELLIOTT: Okay. I appreciate that. I think what Barry was hinting at was I spent 20 years as an investment banker, so I was responsible for the crisis. Then having created the crisis, I thought I'd come here to study it. Washington's the boomtown these days, so it made sense to get out of New York.

What I thought I'd do is talk about two sets of things that are obviously related, and then try to leave you some time for questions. I'll first talk about the state of the financial sector. You know some of that of course coming in, and other speakers I'm sure have touched on it a bit. But let me go through that briefly. And then I'll focus more on the financial reform legislation and what that's likely to do.

State of the Financial Sector

In terms of the financial sector, I'd break it down into a few parts. The big banks are basically out of the woods. They're going to continue to have some loan losses that persist, clearly. However, they have quite a large underlying earnings power, and that earnings power lets them absorb those losses. In fact, for the banking system as a whole, according to FDIC data, the smaller banks are in much worse shape.

But even including them, the banking system made a profit last year, and it made a profit the year before that. A very small profit, it's about $20 billion a year pretax, whereas it normally makes $200 billion-plus pretax. But still it made a profit even with all the troubles. And that doesn't include the investment banking and other noncommercial banking parts of the system, which did pretty well in '09 and should do reasonably well this year.

So the big banks have exited that forest everyone keeps referring to. The smaller and medium-sized banks, however, are facing a lot of trouble.

And if I can briefly digress: One of the things I've found amusing in Washington is that as far as you can tell by talking to people here, the community bankers, the little traditional banks, are saints. They, however, if you actually look at what they did, they helped sponsor the worst commercial real estate bubble we've ever had. A commercial real estate bubble that was worse than the mortgage real estate bubble. And when I say they helped sponsor it, the smaller banks have on average 40 percent of their loan portfolio in commercial real estate. The large banks, about 10 percent. Commercial real estate's an important part of the economy, so it’s going to be a significant percentage, but 40 percent of your lending portfolio is grossly negligent and the regulators should have stopped it and the banks themselves shouldn’t have done it.

Commercial real estate, though, for a variety of reasons, tends to be one of the very last things to produce the loan losses. It’s like the fourth or fifth domino down. And that means that the commercial real estate losses are starting to come through in real size for these banks. And that’s why every Friday the FDIC goes in and takes over four or five banks. And they’re going to keep doing that every Friday because they need the weekend to reconstitute them. They’re going to keep doing that every Friday for quite a long time.

So the smaller and the medium-sized banks are not in nearly as good of shape. Many of them will survive; the large majority will. And I think if you give them another couple years they’ll be in better shape. But they’re going to drag things down.

Credit Crunch?

Now, one reason that’s important is because small business gets a lot of credit from the smaller, more local banks. And one of the things I’m sure that’s been touched on is the question of whether we have a credit crunch in this country or not. It’s actually quite hard to prove, believe it or not. And I don’t think there is a credit crunch for the larger companies. But for medium and small businesses there’s so much anecdotal evidence of a credit crunch that there has to be one even though broad statistics are hard to find. And it appears the main reason for that is that their traditional lenders are the ones who are being hardest hit.

And there’s reason to believe that some of the economic statistics are a little too rosy because they don’t pick up small business as effectively as they do larger business. Annual corrections sometimes take care of that disparity, but the monthly things you see may be a little bit biased.

Now, I’ve spoken to this point as if banks were the entire financial system, whereas of course credit in the U.S. is provided through non-banks or the financial markets themselves. And those you kind of have to divide in two: The capital markets that are relatively straightforward, bond issuance, that sort of thing, are in pretty good shape again. You’ll see that we’re in a period of greater risk and that’s reflected in the credit spreads, but those markets are working pretty well again.

What’s not working well at all is the securitization side of the credit markets. By the way, I’m going to give you numbers, but nobody has really great numbers on this. It’s a somewhat subjective call. This is important because at the peak of the bubble about 40 percent of credit provision in this country was being done through what some people call the shadow banking system, of which a high percentage was securitization. So someone would originate the loan, a bank might do it or a mortgage broker. But they’d originate it knowing that it would be then taken over eventually by investors in the broad markets. If that was 40 percent, it’s probably 10 percent today.

So one of the real drivers of the credit problems we did have and that linger on was the larger evaporation of the securitization markets. That will come back over time. It won’t get back to where it was at its peak because it was excessively large at its peak. But it will come back. It may take a while to get to the long-term stable rate, though.

Financial Regulatory Reform

So let me move on to financial regulatory reform. Let me start by talking about the prospects we’ll actually get financial regulatory reform. I’ve been an outlier for some time in that I’ve been pretty optimistic all along, and I remain pretty optimistic that we’ll get comprehensive financial regulatory reform legislation. And further, I’m optimistic in that my rule of thumb is I think we’ll get about two-thirds of the way to where we should be. Now, Washington’s fairly dysfunctional, and the kind of changes we’re asking them to make in this area are hard even for a well performing political system. So you’re never going to get 100 percent. So I think getting two-thirds of the way there is actually pretty good. And it certainly will make us a lot safer than we were prior to these changes.

Reasons for Optimism About Passage

Why am I optimistic about passage? I’d say there are four points. First is, the politics of financial regulatory reform are very different than the politics of healthcare. The public really wants something to be done on financial reform. They’re not going to understand what; they couldn’t formulate exactly what they want because it’s too technical. But they want something to be done. And related to that, and I’m speaking as an ex-banker here, the public hates bankers. They hate bankers with a passion right now. And so you have them wanting legislation and it being quite obvious that the main people slowing down legislation are people they despise.

And one of the things that means is I am not confident that if push came to shove you would get 41 Republican senators brave enough or stupid enough to filibuster. Now, I don't think it's going to come to that, but the knowledge that that's not a guarantee is an important negotiating leverage for the administration and for the Democrats. Because there are really big downsides to filibustering, being identified with the bankers, and losing. You don't want to be a loser and have backed the wrong side. So that, I think, is a difference in negotiating leverage.

Another factor is many of the things that are going to be done could be done by regulators anyway. In particular, some of the things that will be most expensive for the banks are within the regulatory powers of the agencies now. For example, one of the big things that's important, and there's a pretty broad consensus on, is raising capital requirements. Capital serves as a buffer to protect banks against mistakes and bad luck. And as we saw in the crisis we just went through, you can have a lot of mistakes and a lot of bad luck. We need higher capital levels than we've had. Capital, though, is expensive. They can basically get money at a rate of a couple percent. It's virtually zero for deposits, but they have to have an expensive branch network so there's some cost in there. But capital, things like common stock, costs them, like, 15 percent. So the more they have to fund their loans with capital and the less with just ordinary deposit or debt money, the more expensive it is for them to do their business.

The banking industry largely recognizes there is a need for more capital, but they'd rather have the low end of whatever the range is rather than the middle or the high end. But if we don't get legislation for some reason, if I'm wrong about passage, the regulators clearly will just make those changes. It's within their present authority. And there's some other things they could do on their own. There's not a rush, in general, and so they'd prefer to let Congress give them clear direction. But if Congress doesn't, they will act on their own.

My third point is related to that. I think the banking industry, or at least much of it, has realized that they overplayed their hands in their lobbying at the end of last year. They were starting to show a somewhat scary ability to block almost everything in the way of financial reform, at least in the Senate. The things they didn't like they were being pretty effective about.

But what that ended up meaning was in January and February suddenly you had the Financial Crisis Responsibility Fee being proposed, which is a large bank tax. You had the Volcker Rule being proposed, which would take away their hedge fund operations and their internal proprietary trading operations, which they very much don't want to have happen. And you got a general sense that they should not get too cocky, that there are things that could happen to them that would be difficult for them to stop. For instance, a tax on banks would be a pretty popular thing at this point. And when the Republicans heard Obama proposing it they didn't come out en masse and say no, this is a tax and you can't do this. They've been pretty circumspect. I think because they know it would be difficult for them to oppose as a separate bill.

I was at a meeting that Secretary Geithner was addressing recently. And he sort of upped the ante one more time. He was saying, look, we're going to get comprehensive reform legislation this year. If I'm wrong and it doesn't pass, we're going to keep pushing. But by the way, if I'm wrong and it doesn't pass and so there's some delay, we're going to have to have substantially higher capital requirements than we would have if we got this legislation.

And as I said, that is something they can, working with the regulators, just do. I think the industry has started to realize that it's better for them to have a reasonable kind of compromise package than to provoke reactions that they really don't want.

I think industry also wants something to be done because uncertainty is not good for them. The big banks are all publicly traded companies and markets are allergic to that kind of uncertainty. I used to work at J.P. Morgan, for 15 of the 20 years I did investment banking, and Jamie Dimon is the CEO there. He's a very good CEO. But right now he doesn't know whether he should expand his hedge fund operations, which are actually the largest set of hedge funds in the world, or whether they're going to be taken away from him over a couple years if the Volcker Rule goes through. And there are plenty of other strategic planning issues that he doesn't know what to do. And the markets don't know what he's going to be able to do, and they don't like that.

So I do think it will get through. If I'm wrong and it doesn't get through this year, many of the actions will still be taken. So let me tick off the key things.

I've already talked about higher capital requirements. Those I think are very important. Nothing here is a panacea because this is a very complicated set of issues, but if you only let me pick one, I would go for higher capital requirements because they provide protection against anything that goes wrong. You don't have to guess which thing's going to go wrong. And it's a powerful protective factor.

Related to that we're also going to have higher liquidity requirements. What we found was that the non-banks in particular ran into a problem where they were borrowing very short term and they were committing to longer-term assets. And that's the classic way you get into trouble, is in a bank we used to have the bank runs and people would come and withdraw their deposits. Well, you can do the equivalent thing in the capital markets for a non-bank. So the regulators are going to clearly require significantly more cash on hand and things that can be turned into cash quickly.

Next point is we're going to have even higher capital and liquidity requirements for the largest banks. I agree with what Mark Zandi was saying. I think most people would. There's going to be some banks that are so large that they will represent a risk of a taxpayer bailout in the future. I believe as Mark does that there are actually economic reasons why we need at least a small number of banks of that scale. And here you will get disagreement among many academics. But I think realistically, and I'm happy to talk about it at length if you want, we need some banks that really are of that scale. So given that, all we can do is try to make them safer and minimize the damage if they do go under. So we want them to have tough requirements.

Enhanced Resolution Authority

There's a fairly technical thing I'll mention, A, because it’s important, and, B, because it’s one of the two big political fights, and that’s so-called Enhanced Resolution Authority. What that means is this: Right now the regulators, since about ’91, have had good ability to move in on a bank that gets into trouble. Even before it runs through all its capital, they can force capital to be raised. They can take the keys away. They can fire management. They can do a lot of things. And if it does go under, the FDIC can take these things over and make almost dictatorial decisions about what to do. I mean, there’s some broad criteria by which it makes decisions, but it’s got a free hand and will move very quickly.

We don’t have that kind of authority over non-banks, and that was a huge problem for us. If you think back, Bear Stearns was not a commercial bank. Lehman was not a commercial bank. AIG was not a commercial bank. Some of the biggest problems we had were in situations where the regulators had very limited tools. And this is also part of what brought the Fed into activities that probably weren’t great things for the Fed to do, but they were the only one who had authority that came remotely close to dealing with the actual problem because they can write as large a check as they want, basically.

So there’s a high level of agreement that we need regulators to have authority to deal with big non-banks, systemically important non-banks. The fight comes because there are two approaches to this. There’s the administration’s approach, which I happen to quite broadly support. And by the way, I’ll just mention in passing since I’m kind of a rare duck in Washington, I am a political Independent and a moderate. So you’ll find I support most of the Administration’s proposals on financial reform, but that’s not because I’m a Democrat. I just happen to think they’re right on these. And I do think they’re right on the Resolution Authority. What they’re saying is the powers we’ve given the FDIC for a bank look pretty appropriate for a large non-bank; let’s just expand that. I think that is the way to go.

The Republicans, though, have taken a different tack. They believe that we ought to use the bankruptcy system, as is current law, for non-banks, except in the most extreme circumstances. And in those extreme circumstances where you have a non-bank that’s so important that even they will say it’s systemically important, that you ought to have a separate resolution regime, but it’s one that has to lead to liquidation. You can’t come out the other end with the same institution intact.

I have several issues with this. One of them is their big reason for wanting it to be bankruptcy whenever possible is the belief that it’s harder to write a check with taxpayer money for a bankruptcy. As far as I can tell, they were asleep when we did that for GM and Chrysler. I can’t quite figure out, honestly, why they think the bankruptcy regime makes it that much more difficult for taxpayer intervention. They also have, philosophically, a belief that the bankruptcy approach, which is a much more legalistic type approach, is just a better way to go in general. And I can see that. The FDIC has near-dictatorial powers, like I’ve described. We don’t normally like the government to have that. It’s just I think for an important financial institution we need decisions to be made very quickly and things to settle out.

There will be a compromise on this point, and it's pretty clear the compromise will be we'll do what the Republicans want. Because that's already in Dodd's financial reform bill. That was one of the things he worked out and he's just stayed with.

Consumer Financial Protection Agency

The other big political fight is over the Consumer Financial Protection Agency. Again, there's a strong consensus that the regulators did a very, very bad job of protecting consumers on things like subprime mortgages. Nobody really disputes that it was that bad a performance. The question, therefore, is what to do about it. The administration's proposal, which I support in this case with some trepidation, is that there ought to be an independent agency—the theory being there are a number of reasons to believe that if you have consumer protection in an agency that also does safety and soundness, they will always choose safety and soundness over consumer protection if they perceive a conflict. And there usually will be at least a perceived conflict. The things that end up as big fights are things consumer advocates don't like but are very profitable for the banks. If they weren't very profitable for the banks, the banks would just stop doing it because it's not worth the flak. Profitability is the key to soundness of a bank, therefore you're always going to have at least a perceived conflict on these issues.

However, the Republicans and conservatives in general are concerned that a new agency that's independent and just focuses on consumer protection may go overboard, kind of like the caricature of how the FDA operates. You know, the caricature being that if you have a drug that will save 100,000 lives, but might kill 5 people, you shouldn't do it. They're worried that necessary risk taking in the economy will be cut back considerably by an agency that just bureaucratically decides that what it ought to be doing is stopping risk taking. And they're also worried about another layer of bureaucracy. Plus they don't, in some ways, want regulatory change anyway because they already know how to operate in the environment that exists today. The more new players you put in, the harder it is for them to figure out how to profitably operate.

This one I'm pretty sure will get compromised. And if it does, then I think we've got a bill that passes. Dodd has already compromised very modestly in that he's set up the Consumer Financial Protection Agency inside the Fed, so it's not a truly independent agency. On the other hand, every other indicator of independence — like the President appointing the head, having a separate budget, you can go through a bunch of points — they're all set up so this thing is independent in everything except that it happens to sit inside the Fed. It's not going to stay that way. The compromise is going to be that there's going to be considerable strings attached and constraints placed on the CFPA. And I don't know where in the spectrum it'll end up, but it'll be weaker than Dodd's proposal. But it will have some considerable measure of independence.

Systemic Risk Monitor

Let me just hit three other high-level things. We're going to have a systemic risk monitor. The idea is the regulators used to think if they just regulated every financial institution one by one, then you'd be okay. But of course part of what was emphasized this time around is you're never going to be able to make sure that they're all safe. And when they start falling over, the dominos can just keep going. So there's going to be a role for someone, effectively the Fed, to look out for things like the housing bubble.

I think this is well worth doing. It's low cost. We ought to try it. I don't think it's going to do much good, though. To see why I don't think it'll do much good, just do a little thought experiment. Imagine that the Fed had had all of these authorities and omniscience and everything else you want to give it, and in 2005 it had come forward and said we are inflating a very large housing bubble, this is going to be very ugly if we don't stop it, and, therefore, we're going to require, say, higher down payments, or you name some things that would actually have helped the housing bubble not inflate so much. Congress would have slapped them down so fast because bubbles are fun. Everybody likes a bubble because you have people making money, at least on paper. You have higher employment. You have, in the case of the housing bubble, more and more poor people being able to afford their own houses. Everybody saw themselves with home equity going up and up, and borrowing against it. I mean, this was a fantastic thing. And when something like that seems to be working so well, it's very hard to accept having someone like the Fed come in and say no.

Now, you might counter, as many people have, but, look, that's also what the Fed does in monetary policy. And that's true. On the other hand, we got to that level of independence after many years of seeing central banks without that level of independence and problems developing. We have very good academic theory about how this should work. We have experience to have seen it. And over decades we got to that point. We may get to the same point with this systemic monitoring. But the first crisis or two after this, you're not going to have anybody with the good knowledge of how to do it, the guts to do it, and the political ability to do it.

There's going to be some very modest consolidation of the regulators. We have way too many banking regulators. It's a historic system that developed just out of historic accidents of various kinds. We've got effectively five types of regulators at the federal level, and then every state has its own regulator. And this is a recipe for disaster. We're not going to fix it, though, because in Washington it's extremely hard to make anybody, any organization, go away.

Our one big success here is that the Office of Thrift Supervision, which did a miserable job and was the federal regulator for AIG as well as WaMu and Countrywide, is going to go away. But there has been plenty of support for keeping them around even though there is the clearest case to get rid of them. They're going to go away, but the number of regulators will probably stay the same because now you have the Consumer Financial Protection Agency. I'd love to see more consolidation. It's just not politically feasible, certainly not at this point.

There are a bunch of other things — it's a 1,300-page bill, so there are a lot of things I'm skipping here.

Last thing I'll mention is the Volcker Rule, which I'm sure you've heard a lot about. The part most people focus on is that it's an attempt to eliminate proprietary trading and hedge fund type activities from within the banking system. I've written at length about why I, and I'd have to say most experts, think the proposal is a bad proposal. Just very briefly. Obviously we want to deal with excessive investment risk, but this isn't the way to do it. But the Administration has been pushing it. Congress has not been terribly receptive. The compromise that's going to happen is you will have something in the bill, like in Dodd's bill, that basically tells the regulators, we want you to put in place the Volcker Rule, go study it for a couple years, figure out how you would do it and whether you think you really should, and then come back and talk to us about it.

Since none of the regulators, to my knowledge, actually supports the Volcker Rule, and I do believe it's bad public policy, I don't think it's going to happen. But on the other hand, certainly the Democrats in Congress don't want to diss the administration on something that they've made a big deal of. Especially when they made a big deal of it because it has a lot of surface political popularity. So why tackle that? Just tell the regulators go do it, study it, with the knowledge that it's not really going to happen.

So, questions?

Yes, sir.

Discussion

SPEAKER: Taking that last point, I think what I heard you say is you don't like the Volcker Rule because you think it won't help.

MR. ELLIOTT: I think it'd do harm.

Usually I'm fairly measured about things, I have to say. But this is something I will rail at length about if you don't stop me. Because one reason I've been very supportive of the administration proposals in general is I thought they've done a really good job of striking a balance between greater safety — which means, in some extent, the government telling you to do things — and letting the markets figure out the best ways to operate within those constraints. And the Volcker Rule totally goes against that.

Now, specifically, the administration, even at this point, and this is also true of Paul Volcker who has been pushing it, they cannot define in any reasonable way what proprietary investment is. Let me give you an example of why that matters. Even a traditional, extremely safe bank takes deposit money, and we want some of that deposit money to be invested in securities, not loans. The reason for that is securities are much more liquid. So to help deal with the potential for a bank run, you want maybe 20 percent of the deposit money to go into securities. Those are proprietary investments, in most meaningful senses, and they were bought with deposit money. They have all the earmarks of what Volcker is saying we don't want them to do except for the fact it's not something that bothers him, nor should it.

So what it means is, and there are other examples of this, the only way you can implement a rule that's based on proprietary investment is to decide that the intent was something you don't want. So what will happen is the banks will have to say these securities are held for this reason; those are held for that reason. And the regulators — first of all, if they just accept those intents, then there's no teeth to the rule. So they're going to have to somehow figure out whether you could reasonably have meant to own these for liquidity reasons or to back up trading positions or etcetera.

Now, this isn't just a theoretical argument. Most of the asset-backed securities that were owned by the banks that ended up blowing up were held for liquidity reasons. They were rated AAA and they were highly liquid. So it was a way to hold something that was good for your liquidity position that paid you an extra 50 or 100 basis points. So their intent was actually pure as the driven snow. But that didn't mean they weren't taking excessive investment risk in that area. And there could be another area where their intent actually is proprietary investment but what they're owning is very low risk. It's just not the right way to tackle it, I don't believe.

Sir?

SPEAKER: Who's really benefiting from the low Federal Funds Rate, other than the big institutions that can make money on it?

MR. ELLIOTT: Well, certainly, as you say, the big institutions are. And that is one of the intents. I mean, mostly it's for other monetary policy reasons, but part of it clearly was to help the big financial institutions, and the small ones, too, for that matter, to recover.

But it's possible to really exaggerate the importance of this, so I'd like to emphasize something. I hear people sometimes saying this is a huge subsidy to the banks. All they have to do is take the Fed's Fund money, buy themselves some nice 10-year Treasuries. They're paying almost nothing on the Fed Funds, and they're earning 3, 4 percent. Well, Morgan Stanley's researchers, for example, believe that the 10-year Note over the course of this year will go from yielding 3-ish percent to close to 5. If that happens, owning the 10-year Treasury will be one of the worst things these banks have ever done. So it's true that if the structure of interest rates were to stay flat, this would be a massive subsidy. But if everybody thought they were going to stay flat, arbitrage would have changed the relationships very quickly.

So it has been a help in the short run because banks started with the position of a lot of loans and things that were somewhat longer term. So in the short run, it's been a very significant subsidy. But in terms of looking forward, it's not necessarily a subsidy at all. Well, it gets priced into the whole market and there's not really a benefit, necessarily, going forward. If they do the right thing in regards to the market, it'll work well for them. If they do the wrong thing, it'll work badly.

SPEAKER: But it's not helping the small business that wants to borrow money). That's the other side of this, that it's sort of portrayed to the public that, look, interest rates are really low. And then somebody wants to borrow money, and finds they can't even get money, let alone at a low rate.

MR. ELLIOTT: Yes. Let me turn this into an even more general question, answer that, and then come to your question. But if I'm not specific enough, bring me back.

I have to say I've been a big fan of the Obama Administration's economic policies, in particular in the financial area. I think they don't get nearly enough credit. And the reason I don't think they get nearly enough credit is we almost had a complete meltdown. We could have had a much worse recession than we actually had. I think actions like we're just describing with the low Fed Funds rate and the implicit subsidy at least in the short run for the banks, it kept lending from falling totally off a cliff. It's come down a lot. It would have come down substantially further. So I think the total amount of lending is significantly higher now because of that set of actions, but it's still lower than it was. So I absolutely understand the public anger about all of this, and the confusion about the fact this was all supposed to help lending but lending comes down, but I do believe it has helped compared to what would have happened without those actions.

Yes?

SPEAKER: Yes. A lot of these proposals obviously go to structural issues around the banks, getting a little bit more political, but certainly on the regulatory side. You know, with Michael Lewis' new book coming out, and the 60 Minutes-type focus on why are we paying these people this much for basically not creating anything, to what degree do you think real limitations on compensation may become a part of the regulatory framework in financial services? And from a labor economics perspective, are the cries by the financial services industry that they can't survive with compensation limits that realistic?

MR. ELLIOTT: That's a good set of questions. Let me start again, big picture. Even as an exbanker, my gut feeling is that compensation levels are excessively high in the finance industry. But one of the interesting things I've found talking with a lot of economists is we don't have any way to know. We really don't. It is possible that these compensation levels actually made sense. And the reason I'm going into that is that's also the perspective, as far as I can tell, of the regulators and of the administration. I think it's probably exactly what I described my own feelings as. It feels like it's too high. So if it came down, everybody would be feeling relieved. But they don't know what the level should be.

And so what the regulators are going to focus on, and already have been putting out some rules on, is trying to make sure that the structure of how the compensation is determined, as opposed to the level, is done in a way that doesn't appear to contribute to the risk of the system. And so they're pushing that hard.

If you're interested by the way, I wrote a primer on Wall Street pay. And I waited until I'd been here almost a year because I felt as an ex-banker I wasn't the right person to be the messenger on this. But I wrote the primer in the end because there's still so much misunderstanding of even how this stuff works. The fact is, the bonus system works for 80 or 90 percent of what a bank does. It works for all the people who have sales type jobs or who provide M&A advice or do short-term trading but don't commit to long positions. Where it turns out to work really badly is when you have people who can commit you to long-term illiquid positions. And Wall Street thought they knew how to handle that because they thought they had these risk models that could tell them how much risk there was, and so they'd adjust pay based on risk. It turns out the model stank, and so that didn't work. But we haven't found another way to handle it. But to say you can't use the bonus system at all would be to throw out a system that's worked very well because it doesn't work for a piece of what they do. And so I don't think regulators are going to make that happen.

Now, this is one of the tensions with Europe because the Europeans, partly because they're much more sensitive to inequality than we are, are looking at ways of dealing with what they see as excessive bonuses. And it's a conflict because the U.S. doesn't particularly want to do that.

SPEAKER: You had mentioned securitization early in your remarks and the fact that the volume of that has dropped substantially. I think I understood you to say that that needs to come back, maybe not to the same level. And I guess my question is, is securitization a good thing? I mean, I guess it pretty clearly increases liquidity in the system, but it seems to me it's also a source of substantial lack of transparency in the way these structured products get put together and so forth.

MR. ELLIOTT: Yes. That's a great question and it's one that academics debate and policymakers debate. I think I'm with a fairly large majority of the people who look at this and say, certainly some of what was done, in retrospect, was completely crazy. Like CDO-squareds and things — those aren't going to come back. Relatively new financial instruments tend to go through at least one shock that teaches us that we need to be really careful, and then you work that out. So some of this will be taken care of fairly automatically.

But that does leave the basic question: is something that is vulnerable to problems, is it worth keeping? And I do think it very much is, for the more plain vanilla things. Things like mortgage-backed securities where you just pool a bunch of mortgage loans and send it out almost as-is, just send out the cash flows, do just some very simple tranching. There are many investors out there who would like exposure to mortgages but don't want to buy into a bank, either at the debt or the equity level. So the ability to directly give them a play on that provides them diversification. Having it in a liquid form is important to them. And I do believe that there's actually a net economic gain for society in allowing the banks to originate and move it on. It just needs to be done better.

But the plain sort of mortgage securities, with fairly modest exceptions, didn't give us trouble, except to the extent people were guessing wrong on real estate. If they'd guessed wrong on real estate but without securitization, we still would have had a lot of losses for those people. So not everything that came out of the mortgage crisis is securitization's fault, just a piece of it.

Sir?

SPEAKER: You say you understand that there's a lot of anger at bankers out there. Do bankers understand?

MR. ELLIOTT: They do. They truly do. But when it's in your economic self-interest to see something differently than the public, you will. And of course the public doesn't actually understand finance. It's a complex area. So many of the things that are being said against bankers are just wrong. And so that tends to develop a thicker skin for the bankers. When a lot of things that are being hurled at you are false, it makes it a little easier for you to reject some of the things that are maybe truer than you'd like to accept.

And also, even if they fully accept that they helped blow up the world and that people should be mad at them — and, you know, I'm doing the same thing — I'm saying "they." I was an investment banker. Now, I could walk you through the things I worked on. I don't think any of them did help blow up the world, but that's part of it. You talk to almost any banker and there’s only a small percentage whose fingerprints are all over it and it’s hard for them to say, no, hey, that wasn’t me.

SPEAKER: There’s a group who thinks banking ought to be a more boring business.

MR. ELLIOTT: Oh, yes, there is. And Paul Volcker’s certainly one of those.

SPEAKER: Yes. The Glass-Steagall Act.

MR. ELLIOTT: Yes, it’s just we can’t go back to something like Glass-Steagall because we’ve just gone far beyond that. For example, at the core of Glass-Steagall was if it’s a loan, that’s a commercial banking activity. If it’s a security, that’s an investment banking activity. Well, loans are now done in a way that they can readily be traded. And that’s an important part of the financial system, and I think actually a beneficial part of the financial system. You could argue with me about that, but I do believe it’s beneficial. And it’s certainly completely ingrained in how things are being done now.

So unless you completely unwound that, you couldn’t make a true Glass-Steagall distinction anymore. That’s why Paul Volcker, even though he’d love to roll back to that time period, has focused on proprietary investments and trading instead because at least he thinks he can identify that. Though he didn’t do himself or the cause any good when Congress had him testifying and he couldn’t explain what he meant. It was really like that Supreme Court justice talking about pornography: Well, I’ll know it when I see it. And that’s not a terribly satisfying answer.

SPEAKER: There was a fair amount of financial change in the regulatory industry coming out of the Great

Depression.

MR. ELLIOTT: Absolutely.

SPEAKER: And so it seems to me modestly likely that there'll be more than a modest amount of change coming out of this Great Recession. Whether people understand it or not, I think the change will come.

MR. ELLIOTT: Oh, I absolutely agree. I would argue that actually what's going to pass is in itself a fair degree of change. Not to say there may not be still more in terms of knock-on effects. And also what the market is doing of itself. Because, look, we bankers may be stupid, we're not that stupid.

SPEAKER: No, the problem is you're smart. That was the problem, as it turned out.

SPEAKER: Just greedy.

MR. ELLIOTT: Well, yes, absolutely. Absolutely.

SPEAKER: Well, that you can't repeal. Human nature, you know, you can't repeal.

MR. ELLIOTT: Yes.

SPEAKER: But you can regulate it. I mean, one of the things that people are angriest at bankers about is that they won't loan money right now. Beyond the sins of the past, it's the concern.

What are the chances of unintended consequences that the regulation will actually make it even harder for lending to get going again, certainly at the regional level? A lot of people right now who wouldn't touch regional commercial real estate with a 10-foot pole, and other areas. What are the chances that regulation will actually hurt the problem in that regard?

MR. ELLIOTT: One hundred percent. So the question is, will it hurt it more than all of the other benefits we're receiving in terms of systemic stability? And no, I don't think it will.

I did several pieces of research trying to quantify the effect of higher capital requirements on loan rates and on availability. And what I found matched what I thought going in, which hopefully doesn't mean that I just rigged the paper. But my intuition told me we can handle significantly higher capital and other requirements without destroying the lending market. And that's what the numbers tell me when I do them as well.

But directionally, you're absolutely right. It has to work in that direction.

Sir?

SPEAKER: Don't you think that at the end of the day what everybody's after here is a sense of balance? Take consumer finance regulation: If you have consumers — this is higher education, let's talk about students – if you have students who are unaware of their financial obligations and are not financially literate that's a disaster and causes downstream risk. And it causes risk to the bondholders in the system and to the banks that hold them and make the portfolios. Consumer finance regulation could require transparency to the borrowers, the people who make the loans, the people who get the loans, the schools that are funded by the loans, the bondholders who ultimately are the long-term recipient of that risk and are trying to price that risk. It seems to me that what you're really advocating, which to me makes perfect sense, is some rational balance and logic in the system.

MR. ELLIOTT: Yes, I couldn't have said it better.

That’s exactly it. And one of the things I have said on several occasions is unfortunately the things that would be most emotionally satisfying here will all do us harm. That’s the unfortunate thing. You know, you’d love to go and just do this thing, but when you’ve looked through, it would have terrible consequences. Balance is not nearly as satisfying, but it’s what will make for the better system.

MR. BOSWORTH: Well, on that note I think we’ve come to the end of a long day.

MR. ELLIOTT: Thank you very much.