Financial Regulators Need More Than a Reorganization: The Case For a National Institute of Finance

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Last September top government officials confronted an excruciating choice. Lehman Brothers, one of America’s most important financial institutions, tottered on the brink of bankruptcy. Rescuing Lehman would signal to other large institutions that they, too, could count on an implicit government safety net, no matter how risky their financial excesses. However, allowing Lehman to fail risked setting off a cascade of bankruptcies and market disruptions.

Forced to make a quick decision, officials let Lehman fail. In part, they believed that financial market participants had long been aware of Lehman’s weaknesses and had limited their exposure. However, that decision turned out to be a grave mis-step. Financial firms worldwide were tightly linked to Lehman’s fate by a poorly understood web of derivative contracts. Within hours, world credit markets seized up. The economy, already shaky, began its horrifying downward spiral.

Could officials have foreseen the catastrophic fallout? Perhaps, but clearly at the critical decision time America’s top officials did not have the data needed to fully understand the counter-party relationships linking Lehman to the system. Nor did they have in place any capacity to analyze these data and thereby form a clear picture of the consequences of their two alternatives. They were, to a frightening degree, flying blind.

The current crisis has revealed an important gap: regulators do not have access to the data and tools they need in order to assess counter-party links and monitor financial system robustness. Currently available data provides regulators with a snapshot of a single institution. Furthermore, the lack of counter-party information enabled the Maddof scandal. If available this knowledge would have revealed that Maddof was making no trades, hence exposing the Ponzi scheme. Clearly, given the vital information that flows from the linkages between firms and markets, this state of affairs is unacceptable.

As a solution we propose the creation of a National Institute of Finance (NIF). The NIF would serve as a national data archive and think tank serving the financial regulatory community. The mission of the NIF would be to provide to financial regulators the data, software, computing power and analytic capacity they need to oversee and safeguard the health of the modern financial system.

A centerpiece of the NIF would be a Federal Finance Data Center (FFDC). Participants in the U.S. financial and insurance markets would be required to report all positions to the FFDC at regular intervals. Crucially, these reports would include both exchange-traded and over-the-counter contracts, complete with counter-party relationships. The FFDC would allow regulators to assess system-wide contagion and concentration risks, to perform stress tests on the system, including the impact of the failure of a large institution, and hence make better-informed decisions in times of crisis.
Given the sensitivity of these data to financial institutions and, in broad terms, America, top-level data security would be essential. Financial institutions will have serious, legitimate concerns about third parties learning details about their positions. But the military and national security communities provide functioning models of how to handle such problems. More to the point, there is no alternative. Without detailed information on transactions, positions, and counter-party relationships, any attempt to identify systemically-important institutions is guesswork.

A second major role of the NIF would be to maintain a research center, including a National Risk Lab (NRL) with skilled staff and facilities analogous to those used by the quants on Wall Street. In the spirit of the National Academy of Science, the NIF would act as a clearing house for ideas and problems, between industry and a broader research community: identifying essential problems, sponsoring the sustained research efforts needed to solve these problems and integrating solutions into a rigorously tested, well understood set of models. This work would allow the NIF to work like a product safety lab, providing a widely available set of models as a basis for risk assessment and independent evaluations of models used by industry for computing capital requirements.

To minimize regulatory turf battles and the risk of politicization of analysis, the NIF should not have any direct line responsibility for oversight of financial institutions. Instead, the NIF would act as a neutral player, supplying tools to the entire regulatory community.

Without detailed data and validated decision tools, crisis decision making will continue to rely on guesswork and intuition. With the creation of a National Institute of Finance, a new financial regulatory regime would be equipped with the data and tools to make better decisions—before the next crisis or Maddof comes.

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