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Subprime Finance: Yes, We Still Are in Kansas

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Financial Markets Reform

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Yes, We Still Are in Kansas

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I. Intro

Financial crises, which seemed like such a '90s thing, are back. After two decades with an estimated 130 crises worldwide during the 1980s and 1990s, many had concluded prematurely that the period of calm in most financial markets since 1998 meant that the financial system had evolved to such an extent that crises were an unfortunate experience of the past, except for a few of the usual suspects like Argentina. The end of financial history had arrived, we were told. Especially in advanced economies, new financial instruments were efficiently slicing and dicing risk, parceling it out to those who could bear it best. So prevalent was this view that in a paper on banking crises for the Oxford Handbook of Banking (Caprio and Honohan, 2009) on which work commenced in the spring of 2007, some commenting on the outline advised of the need for a section on the 'end of crises.' Fortunately that paper was not due until last winter, so the comments on the need for such a section rapidly were muted.

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Far from ending, financial history has been doing a great job of hitting us over the head to remind us that the basic forces that motivate human behavior in financial markets are alive and well. As Talleyrand said, 'History teaches nothing, but punishes those who fail to learn its lessons.' Punishments are being meted out in large doses at present, and the pain looks to continue. In this brief chapter I would like to first review some of the 'universal constants' of financial market behavior, or at least the constants when incentives systems are conducive to absurd risk taking and there is very lax oversight by markets and supervisors alike. Then in the final section I will discuss the necessary elements of a policy response. To be clear up front, while eliminating financial crises would be easy, I do not think that societies would like to live in such a state. The

Barcelonan authorities in 1390 finally had enough of bankers gambling with other people's money, and they beheaded a banker outside his bank (Kohn, 2008). This policy response was reported to have been quite effective, killing off not just a risk-taking banker but also any financial risk-taking, and economic growth as well. Most countries today are at a far different extreme – rather than flirting with excessive liability in finance, some financial sector participants enjoy a generous safety net while societies permit staggering levels of compensation to those whose risk-taking leads to the impoverishment of employees and shareholders of financial firms as well as to innocent bystanders.[1] Political economy forces predominate in financial sector regulation – 'them that's got the gold make the rules.' Or at least that is how financial sector regulation has often played out in history. With staggering losses in the current crisis, it will be interesting to see if this time is any different.

Comment [SP1]: There could be something in between

Comment [SP2]: How do you think it will/should be?

II. Déjà Vu All Over Again

It was not so long ago that a crisis was brought on by investors hungry for yield, who decided in large numbers to put a significant amount of their resources into a surefire investment. The firm benefiting from their enthusiasm was the world leader in its field, and best of all the key players there had done it before, making huge sums of money in the process. They had the best talent that one could gather, led not only by those with great success in the private sector but blessed by great political connections as well.

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[1] I presented this paper a few months after the failure/bailout of Bear Stearns (yes the shareholders took a loss, but creditors were made whole) and finalized it the weekend of the government takeover of Fannie Mae and Freddie Mac. (needs updating)

Notwithstanding some early successes, they finally failed miserably, as a series of events that the public was told could not have been anticipated occurred. Perhaps most embarrassingly of all, for the fiercely independent entrepreneurs, government intervention (though not a 'bailout') was necessary by U.S. authorities, the government that most urges private sector solutions on others.

Some hearing this might assume that the above description refers to the 2008 failure of Bear Stearns, perhaps even more recall the LTCM affair, but instead the case in question was the sorry saga (give year) of the Panama Canal (McCullough, 1977). Ferdinand De Lesseps represented the combination of Meriwether, Mullins and Merton, the protagonists of the LTCM drama. He began his career as a diplomat, and then achieved world renown by building the Suez Canal. Surely he was the best at canal building, so he could safely be entrusted with the savings of so many French families – it is estimated that one family in ten lost its life savings in the resulting fiasco, as its shares fell to zero and its debt paid but a few centimes per franc.

Comment [13]: Do your readers all know the story? Does it need explanation?

For while De Lesseps did know canal building, it turns out that building canals through sand and in a dry climate is entirely different than building them through rocky soil with tenacious tree roots and tropical diseases that killed 25,000 workers. The photo of the broken and abandoned machines resembles one from another instance when local conditions were ignored, and that was the Kongwa Groundnut scheme in Tanganyika in the late 1940s.[2] Interestingly, the job that this French private corporation was unable to do was completed by a U.S. public sector organization, the U.S. Army. The Army

Comment [14]: Remove this. It interrupts the flow because you're returning to the Panama story, right? Flow: Bear Sterns→LTCM→Panama→ Tanganyika→Panama

[2] The soil in the Kongwa was perhaps even less friendly to clearing than that in Panama. One observer, quoted at http://www.sjsu.edu/faculty/watkins/groundnt.htm put it this way: "In patches the thickets of scrub are impenetrable. A rhinoceros can force a way through, a snake can wiggle through: but no size or shape of animal in between."

Comment [15]: Succeeded because of indecision of two people in control?

succeeded where a private group did not in part because like many bureaucracies, it had a hard time making decisions, and put two people in control, one of whom was an Army doctor who insisted on not doing anything until they could discover why so many workers were dying. As a result, in addition to building the Panama Canal, they also were the first to note the role of mosquitoes in spreading yellow fever and to figure out strategies to cope with it.

So why is this case relevant? The rush to invest one's money in 'sure things' that will pay a high return seems to be a decidedly human characteristic, even when one realizes that it is a high-risk venture. Consider the statements of two prominent bankers almost 300 years apart in time, John Martin and Chuck Prince:

> "When the rest of the world are mad, we must imitate them in some measure." John Martin, Martin's Bank, 1720

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Chuck Prince, ex-CEO, Citibank, July 2007

Both bankers understood that they were taking risks – Martin in particular had studiously kept his bank out of the South Sea Bubble until just before the end. Many others bought in just before the peak and then liquidated, as did Isaac Newton – selling his investment early on in South Sea Company shares and then buying back in and thereby losing a fortune at the end. Both Martin and Newton seem to have been unable to resist the prospect of riches. As Charles Kindleberger (1989) put it, "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich." Some eternal truths about humans' ability to assess risk and make financial decisions seem evident, and increasingly are confirmed by behavioral and even neuroeconomics, the latter showing that it is the pleasure centers of the brain, rather than its logical parts, that are heavily engaged in these decisions. Individuals are not fully rational in assessing risk, but rather are subject to framing – as Kahneman and Tversky showed – and exhibit myopia, a particular type of framing in which the recent past frames many decisions.

Comment [SP6]: Add references

The general lessons adduced from previous crises depend on the degree of specificity of the observer. While some adhere to a Tolstoy-like view of crises "Every happy family is the same, every unhappy family is unhappy in its own way", there are in fact a number of common features to crises. To be sure, it is true that no crisis in history had the plethora of new financial products or the volume of derivative instruments that at the least contributed to the ability of market participants to disguise what was occurring in the current crisis. However, the incentive to disguise risktaking is hardly new.

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In so many respects, the current crisis is very familiar. Residential and/or commercial real estate booms have been prominent features of crises around the world, notably in Japan (1990s), Malaysia (mid-1980s), Mexico (1994), and Sweden (1991-94), even when overall macro stability seemed assured. High leverage ratios, also a part of the recent crisis, were featured in East Asia in the late 1990s, particularly in Korea. Indeed, Hy Minsky noted that macro stability contributes to financial instability – low inflation encouraging private market participants to increase their borrowing. More generally, economic booms and increasing asset prices have been noted as antecedents of financial crises for as long as modern banking has existed. Asset price boom in equities and property might some day be found to increase the brain's production of some narcotic-like drug, because in most booms the actors seem to believe that 'this time, it is different,' or in other words some exogenous shifts mean that said prices will continue to rise, as seen in each of the above real estate booms, the 1970s oil price bubble, the emerging market lending binge of the 1970s and early 80s, and the tech boom. In each case, as with the recent real estate boom, those who pointed out the possibility of a bubble were told ‘Sovereign debt does not default,’ or ‘housing prices might slow, but never decline,’ notwithstanding historical evidence very much to the contrary.

In addition to what Keynes might have described as animal spirits gone berserk, several factors seem to be at work. First, whenever a block of investors or more usually financial intermediaries, such as banks, reallocate their portfolio in a given direction, although individually without influence on asset prices, as a group their shift tends to increase that prices of the favored assets, which then produce additional portfolio adjustment in the same direction, etc. Although the timing of the portfolio shift might merely be a random event, often there is some economic change that drives it, one common one being financial liberalization. A decline in interest rates on low risk assets often sets in motion a particular portfolio change, namely encouraging investors to venture further out on the risk frontier in search of yield. When real riskless rates are near zero or negative, the temptation to search for yield can become irresistible, and investors’ simultaneous moves make it seem as though the shift is low risk, for returns in the favored object of speculation inevitably rise as the herd piles into it. We have seen this movie before, in each of the aforementioned booms.

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Second, regulatory change often plays a part as well. As countries deregulated their financial systems, they not only removed controls on interest rates and the powers or activities permitted to intermediaries, but often gave them more freedom to reallocate their portfolio, reducing in the process pre-existing requirements to hold high reserves, meet liquidity requirements, invest in government bonds or direct credit in line with government goals. For example, the gradual deregulation in Malaysia in the early 1970s led banks to buy less of what they already held – directed loans and highly liquid claims – and to invest more in property and buildings, which were only a few percentage points of the banking system's portfolio. Every year, real estate and commercial property prices rose and every year the banks decided that in this 'new world' it was sensible to invest still more in this area, with the result that in some years over 50% of new lending went into it. The boom in prices collapsed in the mid-1980s, no doubt as the limits to this reallocation became evident.

Texas banks in the 1970s were hardly much more diversified, investing in stuff in the ground (oil), the ground (property), and stuff built on top of the ground (commercial real estate). No doubt it came as an unprecedented shock when oil prices finally went down, so too did land prices, commercial real estate, and of course the banks. Similarly, as the recent crisis was beginning, hedge fund managers, in their letters to clients, were saying that events that were truly impossible to anticipate led to their losses and in some cases closure. The claim in effect was that the event was a 'black swan,' an event that is not anticipated at least until one example is encountered (Taleb, 2007). To be sure, people are not good at anticipating 'black swan' events – unprecedented or exceptionally rare occurrences, such as the discovery of black swans in Australia, which forced the revision of European belief as to the color of swans. However, the housing bubble, the decline in lending standards, and the financial alchemy of recent years – notably the ability to create AAA-rated securities from those BBB-rated and below – were evident for all to observe and similar waves of excessive risk taking have been all too common

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throughout history. Rather than a ‘black swan,’ an event that is seemingly impossible to anticipate, the current crisis seems all too familiar. Behavioral finance also notes that investors often interpret increases in the prices of the assets that they have purchased as evidence of their own acumen and declines as reflecting events that were impossible to anticipate.

Third, crises have been common before central banks existed to regulate the flow of credit, and before they adopted the position as lender of last resort (LOLR). But after the rise of the LOLR, and with the spread of deposit insurance (roughly 85 countries having adopted it since the 1970s), crises have become much more expensive in their fiscal cost (Caprio, Demirguc-Kunt, and Kane, 2008, and sources cited there). Fourth, new financial instruments, introduced as part of technological progress, deregulation, or advances in finance, often precipitate financial crises, as they lead to new risks or old risks in a new guise. Bankers expanding into new, exotic foreign markets forget that they suffer the greatest information asymmetries vis-à-vis the locals, and often are forced to retrench after serious losses. Securitization not only encouraged home ownership for those who could sensibly afford it but also for those who could not. Loan sales, which many of us were taught did not happen due to adverse selection, occurred in large volumes thanks to this advance.

The unfortunate casualty in this crisis was information: if banks could moves assets and activities off their balance sheets to opaque entities, few thought of the consequence when the banks needed to be able to demonstrate their solvency and could not. Tools to encourage borrowing to buy assets are always justified to help a broader array of people participate in financial markets, but the same tools can be used for greater leverage and of course to generate commissions for some. While some innovations are driven by the demands of the nonfinancial sector – swaps are a splendid way to lower financing costs and meet the risk preferences of companies – they also regularly are motivated by the desire to exploit the government's safety net or the wish to avoid regulation (see Caprio, Demirguc-Kunt, and Kane, 2008).

Another common feature of financial crises is that actors in the sector will attempt to weaken bonding (the incentives that encourage behavior more in line with the long term interests of the firm) and accountability. One mechanism is for the payment of lavish compensation for high current returns, allowing risks to be understated (see Barings in the 1990s, UBS and Bear Stearns more recently). Yet ***whenever*** compensation in financial services advances significantly, one should always suspect that excessive risks are being taken. That these risks have moved off an intermediary's balance sheet does not mean that they have departed the planet. With little disclosure, supervisors' and market participants' investigation often stopped at the balance sheet of the intermediary. In the past, how to deal with excessive risk taking was understood: bank officers used to have to post bonds, out of which losses could be deducted, and their bonuses were deferred. More recently, enormous compensation induced great risk taking, and left us with some institutions that incurred enormous risk, and understood what they were doing, and others that were also taking great risk, but did not understand it at the time.

Comment [SP7]: Why?

Comment [SP8]: Could you be more specific: When? How?

Banks and ratings agencies applied seemingly sophisticated models with patently myopic assumptions – ignoring the correlation across adjustable rate mortgages when interest rates rose and housing prices decelerated, let alone declined. When judgments seem to be beyond belief in their shortsightedness, one should look elsewhere for answers. In this case, incentives were encouraging originators, packagers, raters, etc. to get on board and not raise questions.

And here is a key point surely worth emphasis: in addition to the scandalous incentives in the financial services industry – money flowing into intermediaries and ratings agencies and out to their principals in astonishing amounts – there was the scandal in supervision. Where were the canaries in the coal mine? Clearly in this latest crisis, evidence of market failure and government failure has been in ample supply! The critical supervisory failure in my view is that supervisors, as sanctioned by Basel (not surprising, as supervisors have dominated that discussion), have focused on the disclosure of information to supervisors and not to the public. Given the information problem in finance, this is the wrong orientation. Supervision should want as many informed observers as possible so that they can learn from the market and concentrate their always-scarce resources where most needed. What did supervisors know, and when did they know it? Did they not understand that risks were not being fully removed from banks' balance sheets? Did they think that housing prices were going to rise without limit? Unfortunately it is difficult to hold supervisors accountable, as society does not have the information, or the mechanisms, to answer these questions.

Comment [SP9]: Surely there were worse ones, like allowing off-balance transaction to have very little capital, and many others.

Comment [SP10]: How can "the market" understand risks in complex instruments?

Comment [SP11]: What about accountability of private actors?

The regulatory community often is late to detect problems. This is due to skill gaps – the private sector can draw the best talent by virtue of high compensation levels – and because official supervisors either can be restrained directly or indirectly by politicians, or face unfavorable incentives, such as that of covering up problems that emerge on their watch.

Comment [SP12]: "best" in what sense?

Finally, all of these historical lessons occur against the backdrop of the fragile nature of fractional reserve banking. Banks are highly leveraged, opaque, engage in maturity transformation, offer demandable, short-term debt, and have assets denominated in fiat currency (Caprio and Honohan, 2009). Summarized in this fashion, perhaps the surprise is not that crises occur, but that there are not more of them! While all of these factors were at work in the latest crisis, perhaps the most notable was the degree of opacity, which surprised many. Lulled by the favorable credit ratings that many securitized products received, investors failed to do due diligence on their purchases and officials sanctioned their lack of effort through various regulations that require the purchase of highly rated paper and by giving a 'seal of approval' to Nationally Recognized Statistical Rating Organizations to perform such ratings (Caprio, Demirguc-Kunt and Kane, 2008, and articles cited there by Sylla and Partnoy). Although this particular feature of the crisis is new, the phenomenon of investors thinking that their assets were much safer than was realized ex post is familiar. In times past they were assured by bankers and stockbrokers of the safety of their portfolio, whereas this time the bankers and securitizers paid the ratings organizations quite well to obtain such encouragement.

III. Policy Fixes: Something Old, Something New

The key lessons of history summarized in section II offer an agenda for policy reform. It is assumed that the goal of regulation is not to have the safest possible financial system, because while a very safe system would be possible, the cost would be too high – as noted above in 14th century Barcelona. Rather the goal should be a financial system that

Comment [s13]: Please clarify.

takes *prudent* risks in supplying a large volume of useful financial services efficiently, to the broadest part of society, and with the least corruption. In other words, societies value an array of goals: financial sector development, the cost of producing those services, the stability of the system, access to these services, and limited corruption in the sector.

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The lessons of history reviewed above then suggest the need to rethink the approach to regulation and supervision in the wake of the crisis and especially to take account of the dynamics of the regulatory game. In other words, as we have just seen, any static set of rules will end up inducing innovations that help evade the same rules. Ed Kane (2000) and Joseph Stiglitz (2001) have written on this issue at length, the point being that a fixed set of rules in financial regulation is about as useful as a Maginot line. Yet many are proposing a new fixed line every day (e.g. slightly adjust the Basel II accord, abandon or adopt more fully mark-to-market accounting, etc.), and only a few, such as Charles Goodhart and Avinash Persaud, who recommend automatically varying capital with the cycle, take account of the dynamic game nature of the problem. Yet static approaches must fail. Thus, the 1988 Basel Accord introduced the notion of arbitrary risk weights for different asset classes. The ensuing boom in securitization might have partly been in response to other factors but surely was an attempt by banks to shed assets with higher risk weights so as to economize on their cost of capital.

Many government officials seemed to take securitization as a sign of strength, noting that banks were passing on risks to those who could bear them best. At the same time, compensation levels had exploded in the financial services industry, a sure sign that excessive risks were being taken. Nonetheless, supervisors stuck to their approach to risk-based supervision, only adding further complications to the planned approach in

Basel II. Supervisors instead should have been trying to reduce the growing opacity of the industry and uncover the sources of increased risk.

A dynamic system has to have as many participants as possible with the incentives to uncover new forms of taking risk wherever it is going on in the sector, and then compel supervisors to act on the basis of the signals provided. A top priority for reform then should be revising the approach to the incentives of supervisors, and indeed what we ask of supervision. The cornerstone of prudential supervision has been the information that banks have to disclose to supervisors. Unfortunately a good part of the information conveyed to supervisors does not get disclosed to markets, which not only limits market discipline but reduces society's ability to hold officials accountable. At times, of course, officials inevitably will have their hands tied by the political process, such as when lobbying by Fannie and Freddie resulted in a 'regulation-lite' model, as preferred by Congress. So in addition to ending the static nature of supervision is the need to revamp the job description. Rather than having the focus of supervisory efforts be to get banks to reveal information to officials, who then would interpret it or conceal it, supervisors' main job instead should be that of requiring far greater information disclosure to the public and of verifying that information, meting out significant penalties when it is false or misleading.

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Comment [I14]: So how do you regulate without fixed rules (lines)? More disclosure. Add the question?

Comment [I15]: And the administration?

Comment [SP16]: But some argue more transparency could lead to more volatility.

It would even be timely to debate whether supervisors should be allowed to keep any information confidential that is pertinent to the health of individual institutions. Although the disclosure of significantly negative information could lead to a run on a bank, allowing information to remain confidential until it threatens the financial system risks far larger damage and compels most governments to extend safety net support. If supervisors have any private information, they might not act on it, yet the public will never know. And if it is so difficult to deduce the risk positions of financial intermediaries, then it would seem useful to have as many 'watchful eyes' on their activities as possible. Some in the supervisory community view this recommendation as reducing the importance of their function. In fact, although it would permit more active monitoring by markets, especially those with a pecuniary interest, it would both be making supervision more practical – giving supervisors a task that could be accomplished – and more likely to help improve the safety and soundness of banking. Most importantly, more complete disclosure allows society to monitor supervisors and hold them accountable, and would make it easier to reward and punish supervisors with the granting of large, deferred bonuses (pensions) and their forfeiture in cases of costly supervisory negligence.

Comment [SP17]: Given the complexity pervasive, would the public be able to understand the risks? Seems unlikely

Second, it is clear that market participants need incentives to use information. If all participants are credibly insured, then they will not have the incentive to use the information. So some creditors need to be credibly uninsured, so that they have the incentive to monitor intermediaries. A long-standing proposal to require that banks issue subordinated debt in lumpy amounts (e.g., creating creditors with much at stake) and at regular intervals, is a sensible way to do this. More recent proposals to have banks buy insurance or credit default swaps (Evanoff and Wall, 2000; Kashyap, Rajan and Stein, 2008; Caprio, Demirguc-Kunt and Kane, 2008) share the same strategy, as the creditors or insurance providers would be exposed to a downside when banks fail without the ability, which shareholders enjoy, to profit from increases in their risk taking.[3]

Comment [SP18]: But CDS have become part of the problem as AIG difficulties and bail out showed.

Banks oppose this strategy, because they view that it would be costly for them and their managers. Consider the reaction of subordinated debt holders or insurance providers to a significant rise in compensation in a bank. Given their financial interest, they would press banks for more information to be sure that risk was not on the rise, and if unable to so convince themselves, they would sell the debt or demand an increased premium, limiting banks' ability to continue the practice. Subordinated debt acts to complement bank supervision – since these creditors face no upside to risk taking and are the first after equity holders to sustain a loss, they are highly motivated to monitor the institutions whose debt they hold. Since this 'run' would be highly visible, it would force supervisors to concentrate their resources where needed, and could allow them to close banks while net worth is still positive.

Even though creditors might be wary of intermediaries paying substantial compensation levels, nonetheless there is a long history – including the Panama Canal episode – of investors and creditors being too trusting. Also, as has been seen in recent years, the market seems to have a difficult time limiting compensation where information on risk positions is imperfect. Thus it is possible, and worth discussion, that authorities might need to help the industry in this regard. The least interventionist step would be to require significantly more disclosure about the level of, and even more importantly the mechanism for decisions on, total compensation in financial intermediaries. This would

Comment [I19]: ?

[3] What needs further debate is the role of regulation in the subordinated debt and/or insurance market. For example, does the government need to qualify the writers of credit default swaps on banks or assure the existence of the resources to cover the contract? (also the Mehrling point, whether private insurance against systemic risk makes sense?)

have to be enforced for any intermediary, hedge funds included, above a certain size, because even hedge funds once sufficiently large can pose systemic risk. Further along on the interventionist path is to consider having supervisory ratings – such as the CAMELS ratings – a function of compensation. In fact, one can argue that in assessing management and risk management systems, the most important ingredient is how firms compensate risk takers. So the supervisory agency could give lower scores to firms that award more generous current compensation and high scores to those with a greater percentage deferred far out into the future. The latter would help management avoid paying out high compensation to those whose decisions led to the firm's portfolio to 'blow up' after their compensation was already paid out.

Comment [SP20]: Would this imply higher capital requirements for those with lower scores?

Regulation also can improve incentives by exposing to the legal system those who manage other people's money. The requirement that various intermediaries only hold highly rated paper allowed those managers to hold securities that they should have known were risky; in effect, it protected managers from being accountable. Instead, the requirement for money managers should be that they exercise the highest degree of fiduciary responsibility in line with their published objectives. Money managers then could face lawsuits for improper conduct, subject to the interpretation of the courts after listening to other financial experts.

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Additionally, the government should de-license ratings firms, that is return to the pre-1975 era when there were no Nationally Recognized Statistical Ratings Organizations. Instead, governments can look to ways to encourage the quality and availability of financial sector information, such as by subsidizing entry into the ratings business. The same legal liability that money managers face should be extended to those who rate

Comment [I21]: Of licensing?

firms, so raters should be compelled to publish more information about their ratings and courts need to hold the principals of these firms liable for their pronouncements.

Comment [SP22]: Would suggested measures have been enough to prevent this crisis? Seems unlikely.

These recommendations contain elements of what used to help limit risk taking in finance, as well as distinctly new features for the regulatory landscape. Providing supervisors with both carrots and sticks and ensuring that they and managers of financial intermediaries have incentives compatible with society's goals for the financial sector are not new ideas. For example, the idea of bonuses for supervisors is an old idea that dates back to at least the early 19th century in the case of the Suffolk Banking system. And having bank officers post large bonds dates back to the origin of modern banking. So while the precise ways in which risktaking bank officers have been robbing shareholders, sometimes creditors, and of late taxpayers are novel, the principle most certainly is not. Getting the government out of the business of certifying rating agencies is very much a return to the status quo ante. Greater disclosure of information, including of compensation, is new, and is a response to the complexity of modern finance and runaway compensation levels. Whereas in the past some weight could be put on a reputation mechanism, the value of reputation derives in large part from how it helps the bearer earn compensation in the future. When intermediaries pay out what used to be regarded as a multi-generational fortune in a single year, the return to maintaining one's reputation shrinks markedly.

It is clear that political economy considerations drive financial sector regulatory choice. Barth, Caprio, and Levine (2006) showed that the private interest view does a better job in explaining regulatory choices than that based on the public interest. However, the current crisis, by fundamentally shaking up the financial services industry, at least in the United States and United Kingdom, offers a greater opportunity to re-shape the rules of the game in finance than at any time since the 1930s. That regulatory effort attempted to confine risktaking and greatly limit what the sector could do. The globalization of financial services makes it difficult to impose draconian restrictions, and suggests instead that the attention of reformers be concentrated on incentives and information. In 2009, with the new U.S. administration, we shall see if the crisis was sufficiently large to provoke the needed reforms. The crisis has revealed that the financial system 'is still in Kansas,' meaning that many of the forces shaping finance and leading to unwise risktaking continue to rule. The regulatory debate promises to show whether we are ready to leave Kansas yet, or not.

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