

# Righting What Went Wrong

BY CHARLES GERENA

**“Prudential Discipline for Financial Firms: Micro, Macro, and Market Structures.” Larry D. Wall, Federal Reserve Bank of Atlanta Working Paper 2010-9, March 2010.**

Federal Reserve economists have been busy dissecting the 2007-08 financial crisis and evaluating various reforms of market regulation. In this paper Larry Wall at the Atlanta Fed discusses ways to strengthen market discipline at financial firms as well as revise government supervision at both the firm level (microprudential) and the market level (macroprudential).

Wall argues that the owners and managers of a financial firm won't manage their risks prudently unless they bear the costs of poor management practices. “If the government bears most of the risk of loss, not only will the managers lack adequate incentive to manage the risk,” he notes, “but the government is likely to insist on playing a major role in the firm's risk management.” And regulators can't observe or second-guess every manager's financial decisions.

Wall suggests that a microprudential supervisor should regulate a broad spectrum of firms, which encourages information sharing among supervisors of different sectors. As for macroprudential supervisors, Wall says they should be bold in their efforts to understand major threats to the financial system, but modest in their ambitions.

“Macroprudential supervisors cannot guarantee an end to all financial instability, and trying to attain such a goal could be worse than having no macroprudential supervisor,” Wall notes. Aiming to prevent all instability will create “an incentive to severely limit the financial system's capability to innovate and to take risk.”

Wall does offer several options for mitigating the chances of large losses turning into a full-blown crisis. A special resolution regime could help shut down insolvent firms that are systemically important, thus avoiding the instability that may result from a bankruptcy. Or, firms could be required to develop their own resolution plan. Regulators could also reduce the probability of failure by obtaining the commitment of private investors to recapitalize failing firms.

**“Financial Statistics for the United States and the Crisis: What Did They Get Right, What Did They Miss, and How Should They Change?” Matthew J. Eichner, Donald L. Kohn, and Michael G. Palumbo, Federal Reserve Board Finance and Economics Discussion Series 2010-20, April 2010.**

Could more and better data on risky mortgages and securitization have averted the financial crisis? Donald Kohn, vice chairman of the Federal Reserve Board of

Governors, and two deputy associate directors of the Board's research and statistics division evaluate the true benefits of improved data collection in this paper. Their general conclusion is that, while gaps in data and analysis prevented market participants and regulators from recognizing the vulnerabilities building up in the financial system, filling those gaps is only one step in developing an early warning system.

“The information delivered by expanded and improved, but essentially static, aggregate data can (and should) be relied on for signals akin to grainy images captured by reconnaissance satellites,” the authors note. Such images are suggestive, but aren't conclusive by themselves. “Improved data collection can provide the greatest value by highlighting changes and inconsistencies that bear further investigation using other, more-focused tools mobilized to deal with a particular anomaly.”

**“Nonlinear Effects of School Quality on House Prices.” Abigail J. Chiodo, Rubén Hernández-Murillo, and Michael T. Owyang, Federal Reserve Bank of St. Louis Review, May/June 2010, vol. 92, no. 3, pp. 185-204.**

The quality of a neighborhood's schools is one of the factors scrutinized by families during their house hunt. So, it would be logical to expect that factor to be reflected in home prices. Researchers at the St. Louis Fed argue that these variables have a nonlinear relationship: The home price premium grows as school quality increases.

For one thing, families who value education more than others will compete with one another for homes in neighborhoods with the highest-quality schools. Alternatively, families may choose homeschooling or private schools to give their children a better education if they live in lower-quality school districts. Therefore, the quality of the neighborhood public school is less important to them and has less influence on home prices.

The authors further hypothesize that school quality can be considered a luxury good, so people in richer neighborhoods will pay higher home prices for the same marginal increase in school quality.

To test this effect, the paper's authors used housing prices, math test scores for the St. Louis metropolitan area, and other data. “Unlike most studies in the literature, we find that the price premium parents must pay to buy a house in an area associated with a better school increases as school quality increases,” the authors note. “We also find that the racial composition of neighborhoods has a statistically significant effect on house prices.” **RF**