Regulatory Issues

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Overview

✓ 3 key issues

1. Macro imbalances
   - Macro-prudential surveillance
2. Principal/Agent Problems
   - More intensive supervision and regulation of compensation
3. Moral hazard
   - Intensive supervision of Tier 1 Financial Holding Companies
   - Higher, better quality capital requirements
   - Living wills
   - Broadened resolution authority

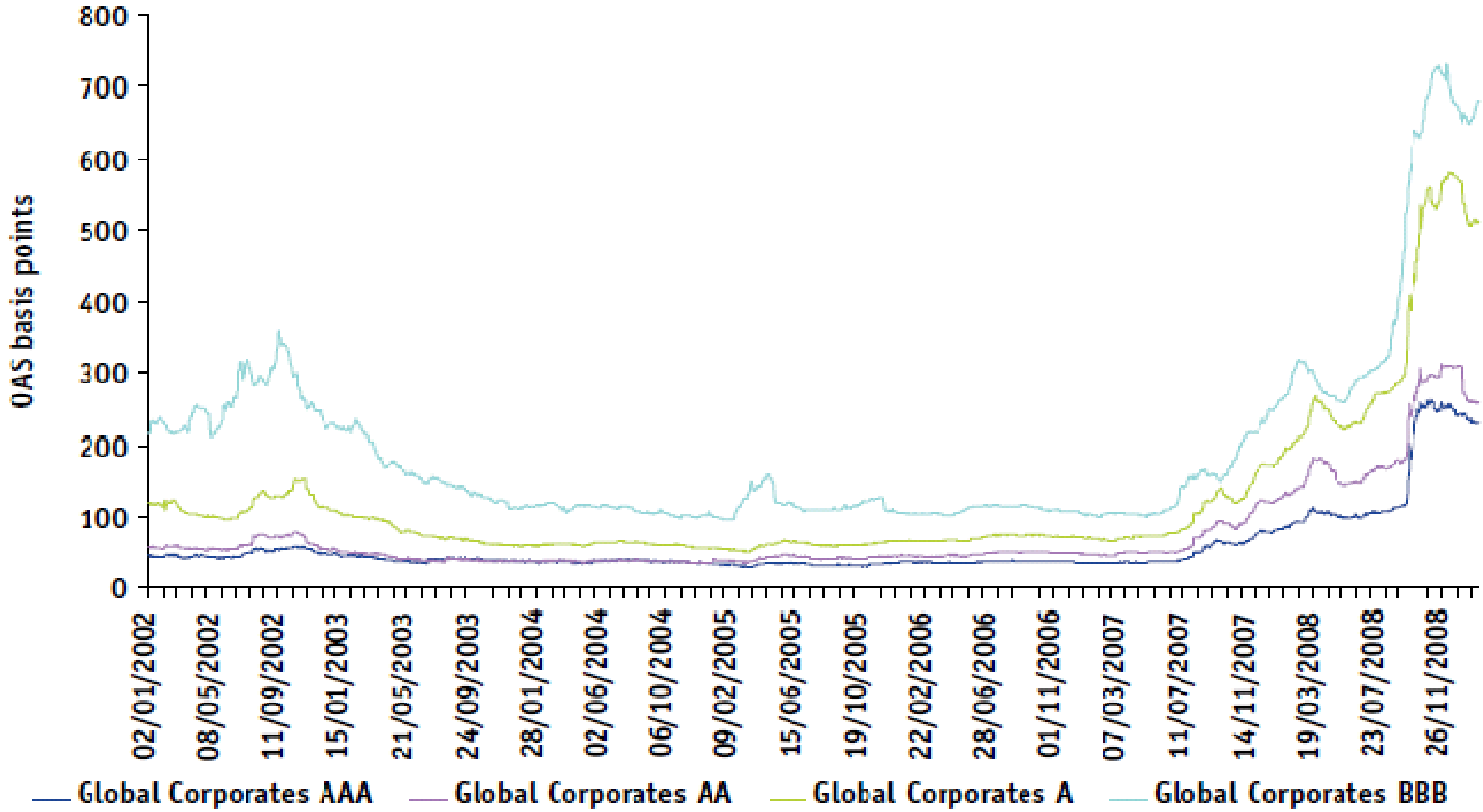
1. Macroeconomic Imbalances

The basic pattern is all too familiar

- From scores of countries over hundreds of years*
  - An extended period of placid financial conditions – "The Great Moderation"
  - Massive capital inflows
  - An increase in leverage
  - A decrease in risk aversion as institutions reach for yield
  - An asset price bubble, that ultimately bursts

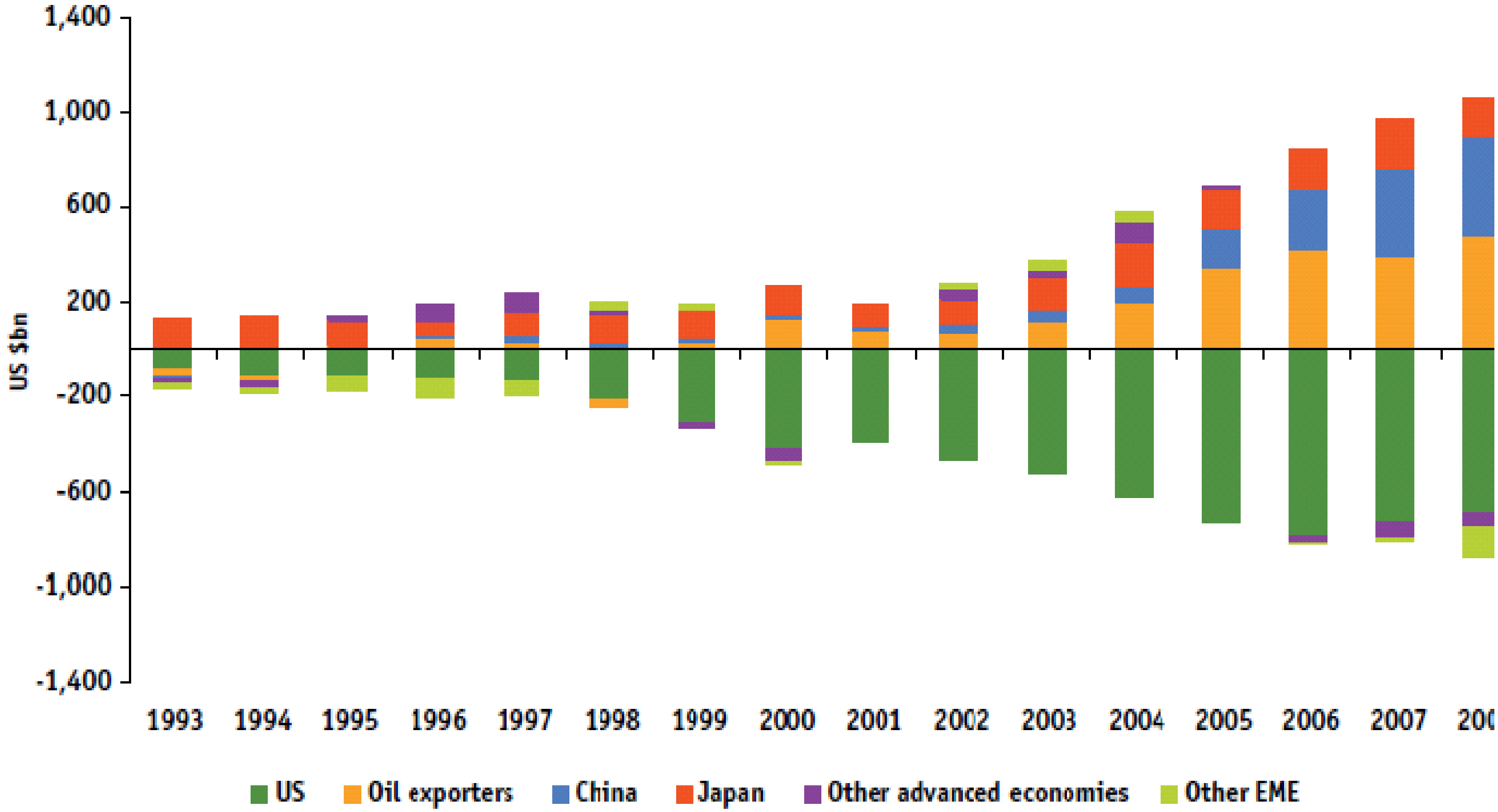
*See Rogoff and Rheinhart

The "Great Moderation" Corporate Bond Spreads



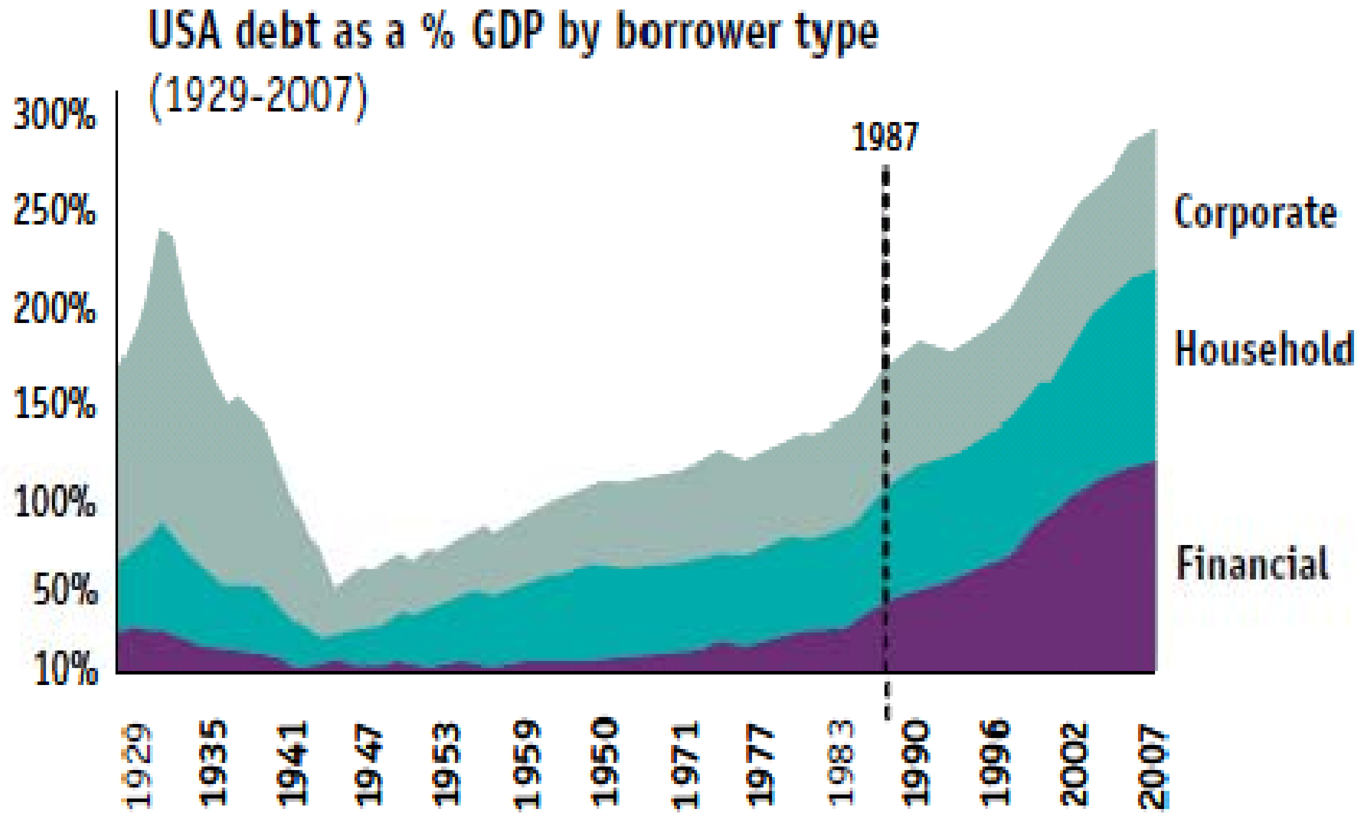
Source: Bloomberg

Huge Capital Inflows to the U.S.



Source: IMF, FSA calculations

US Debt as a % of GDP by Borrower



Source: Oliver Wyman, Turner Review, p. 18.

Real Housing Prices, 1975-2006

Source: U.S. Office of Housing Enterprise Oversight

What Administration has proposed

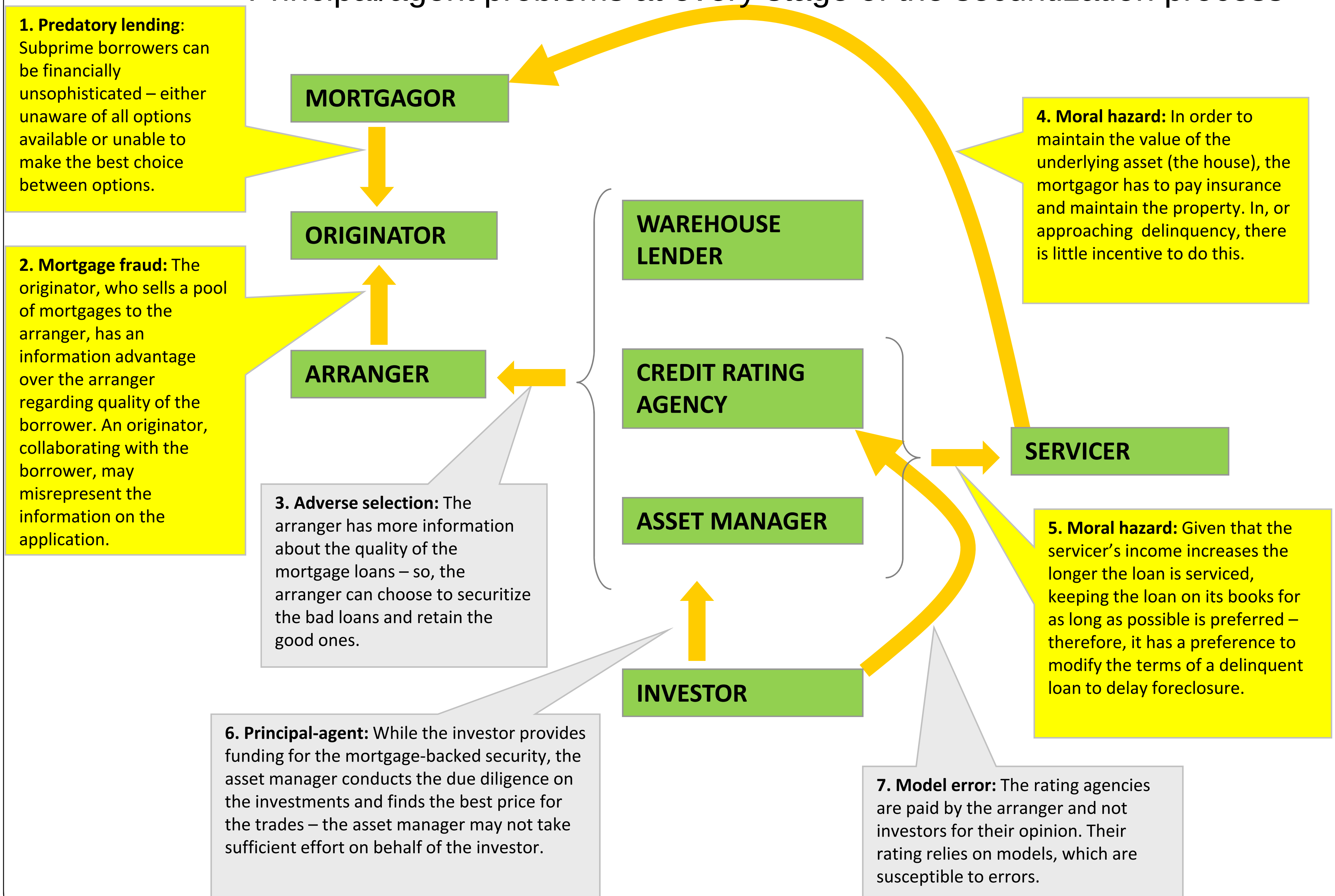
✓ Financial Services Oversight Council (FSOC)

- Chaired and staffed by Treasury, but including heads of all federal regulatory agencies
- Mandate
  - Indentify gaps in regulation and prepare an annual report to Congress
  - Identify Tier 1 FHCs to be supervised by Fed
    - Defined as firms whose failure could pose a threat to systemic stability due to size, leverage, interconnectedness, etc.
      - Ducked issue of whether should be publicly identified
- Concerns
  - Will agencies actually work together effectively in the future?
  - Will Fed supervise FHCs more effectively than it has supervised BHCs?
  - Will identification of Tier 1 firms intensify moral hazard?

2. Principal/Agent Problems Are Usually Blamed for Crisis

- ✓Sloppy due diligence
- ✓Poorly designed incentives
- ✓Inadequate monitoring
- ✓Weak analysis
- ✓Fraud

Principal/agent problems at every stage of the securitization process



Source: Ashcraft and Schuermann (2007): "Understanding the Securitization of Subprime Mortgage Credit"

Administration has proposed Consumer Financial Protection Agency

- ✓ Single agency with authority and accountability to make sure that consumer protection regulations are written fairly and enforced vigorously
  - Designed to remove gaps in federal regulation and enforcement and improve coordination with states (but does not take on investor protection responsibilities of SEC & CFTC)
  - Aim to improve transparency, simplicity, fairness, accountability and access in markets for consumer financial products and services
- ✓ Concerns
  - Conduct CRA examinations
  - States to have ability to adopt and enforce stricter laws
  - Have dropped insistence on agency-defined "plain vanilla" products

Administration has proposed oversight of compensation

- ✓ Established compensation czar for recipients of TARP funds
- ✓ May require originators to receive a portion of compensation over time, contingent on loan performance, rather than lump sum at origination
- ✓ Ban compensation that encourages intermediaries to put investors into products that benefit intermediary, but are not in best interests of customers
- ✓ Require non-binding shareholder votes on executive compensation packages
- ✓ Establish guidelines that align compensation with long-terms shareholder value and do not provide incentives for excessive risk-taking

But Regulation & Supervision Contributed as well…

1. Pervasive use of ratings – outsourcing oversight of credit risk
2. GSEs became eager buyers of AAA-rated sub-prime securities
3. Big 5 investment banks because VCEs regulated by Basel II
4. Basel I created enormous incentives to do business off b/s.

3. General policy of protecting creditors has undermined market discipline

Bailout logic worked for Bear, but not for Lehman

- ✓ Why? Lehman was more than twice as large
  - In the wake of Fannie & Freddie conservatorship wanted to limit expectations of future subsidies?
  - Bernanke has said, "We could not save Lehman." But no compunctions about saving AIG two days later.
    - Fed had examiners in all remaining 4 I banks after Bear and felt they could predict and sustain the consequences?
    - Lehman lacked appropriate collateral?
- ✓ A private deal for Lehman may have been complicated by market expectations of a last minute government subsidy à la Bear.
  - Why dilute shareholders when a bailout is likely?
  - But when it was evident that no subsidy was available, both Barclays and Bank of America withdrew.

Markets reacted sharply to uncertainty

- Massive flight to quality
  - Treasury bill rate became negative for a brief period
  - Differential between 3-month LIBOR and 3-month T-Bill reached 3.47%
  - 2-year swap spread between LIBOR and Treasuries reached record high of 1.66%
- Huge outflows from institutional money market mutual funds
  - Normally liquid markets seized up
  - Fears that problems at Reserve Primary Fund and Putnam would spread to retail market
- Treasury reacted with an impromptu guarantee

Bailouts & Moral Hazard are problems not just because of cost to taxpayers

- ✓ During crisis, wastes resources and may increase incentives for risk taking
- ✓ Delays creative destruction that is essence of dynamic capitalism
- ✓ Provides incentives to become increasingly complex and opaque
  - Perversely, government often facilitates by merging large, complex firms
- ✓ After the crisis, provides unwarranted competitive advantage to institutions perceived as too complex to fail
  - Can fund themselves more cheaply
  - Collect revenue for issuing guarantees they cannot honor
  - Introduce products they do not understand

The Obama Administration's Answer is a new Resolution Authority for Systemically Important Financial Institutions

So far only a quick rewrite of US bridge bank authority from FDICIA.

-But FDICIA has failed to work for systemically important banks

--Has failed to confront the problem of cross-border complexity

No Matter How Effectively Regulatory Agencies May be Reformed…

- ✓ They will not be able (nor should they try) to prevent all failures of systemically important institutions
  - The kinds of rigid controls that would be necessary would surely stifle innovation and risk-taking to such an extent that they would undermine the static and dynamic efficiency of the financial system
  - Regulation and supervision must be supplemented by market discipline, but that depends on having a credible way to resolve a faltering institution, even if it is systemically important.

The 16 LCFIs have 2.5 x more majority-owned subsidiaries than the 16 largest non-financial firms

- ✓ **The most complex FI has 2,435 majority-owned subsidiaries, 50% of them chartered abroad***
  - Some subsidiaries required by home or host countries
  - Some subsidiaries formed to minimize regulatory burdens
  - Many are formed to minimize tax burdens
  - Some FIs may view complexity as increasing the likelihood of a bailout
- ✓ Since policy makers have produced incentives for FI's to adopt complex corporate structures one solution is to require tax authorities, regulators, disclosure authorities and accountants to reexamine all rules that induce FIs to form so many subsidiaries

*See Herring & Carmassi "The Corporate Structure of International Financial Conglomerates: Complexity and Its implications for Safety & Soundness," forthcoming in the *Oxford Handbook of Banking., Ch. 8., working paper 2007*

Also Pressure FIs to Simplify Corporate Structures

✓Require each institution to file and update a winding-down plan just as it currently files a business continuation plan*

- Plan must be approved by board of directors, primary supervisor and college of supervisors
- It should include
  - A mapping of subsidiaries into lines of business that must be resolved
    - Explain each step and time required to shut down each subsidiary
  - Current data on insured vs. uninsured deposits
  - The current net value of all OTC positions vis-à-vis large institutions
  - Results of a stress test coordinated with other systemically important institutions
  - Report number of days required to wind-down institution
- If plan is unsatisfactory, may require consolidation of some subsidiaries, reduction of exposures to some opaque activities

*See Herring & Carmassi "The Corporate Structure of International Financial Conglomerates: Complexity and Its implications for Safety & Soundness," forthcoming in the *Oxford Handbook of Banking., Ch. 8., working paper 2007*

Would the preparation of winding -down plans have led to less disastrous outcomes for Lehman Brothers & AIG?

<u>3 reasons justify some degree of optimism</u>

1. Preparation of a winding-down plan subject to board and regulatory approval might have caused them to
   - grow less rapidly,
   - adopt less internationally complex corporate structures and
   - engage in less systemically risky activity
2. Regulators might have been more alert to the increasing fragility of the system and thus better prepared
3. If the worst happened, resolution authority would have had clear plans for winding-down institution in least disruptive way
   - US liquidator of Lehman has said that $75 billion was lost because of ill-prepared bankruptcy proceedings