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Statement of the Shadow Financial Regulatory Committee on

An Open Letter to President Obama

December 10, 2012

In the arena of financial regulation, the Congress and your administration face a logjam of unfinished business and perverse lobbying pressures. The open letter that the Shadow Financial Regulatory Committee sent you four years ago (Statement no. 264 – December 8, 2008) identified five festering areas of special concern: 1) prudential regulation and supervision of financial institutions; 2) government policies that subsidize homeownership and housing activity; 3) rules defining the limits of safety-net protection for the financial system; 4) policies governing financial-institution consolidation and competition; and 5) disclosure standards and other rules ensuring transparency in complex financial instruments and deal-making arrangements.

Although the passage of the 2010 Dodd-Frank Act creates the appearance of progress, the Act does not settle any of these issues and actually increases moral hazard. Uncertainty about when and how these five issues will be resolved continues to impede business and household investment and job creation.

1. Problems of Dodd-Frank: The Dodd-Frank Act was enacted as the U.S. was recovering from one of the most serious financial crises in its history. Congress and the administration were eager to place their stamp on legislation that responded to the crisis. They acted hurriedly to respond to public demands for them to “do something”

to prevent the recurrence of the crisis and ease the recession that followed. In the two and a half intervening years, many elements of Dodd-Frank have come to light that exacerbate—rather than mitigate—the problems that gave rise to the crisis. These are outlined below in the hope that you will urge Congress to undertake needed reforms.

First is the fact that the crisis itself was less a failure of regulation than a failure of supervision. Heavily regulated banks did no better than lightly regulated investment banks. This should have raised questions about enforcement and regulatory performance rather than about the efficacy of the rules that were in place. Nevertheless, the crisis was seen as a rationale for developing more stringent rules. Second, many of the reforms put into place by Dodd-Frank gave more support to the idea that the government will protect the creditors of large financial firms, thus increasing moral hazard and reducing market discipline. Title I, for example, designates every bank holding company with \$50 billion or more in assets as “systemically important,” and subjects these 25 U.S. institutions to “stringent” regulation by the Fed. It also authorizes the Financial Stability Oversight Council to designate certain nonbank financial firms as systemically important, and subjects them, too, to stringent regulation by the Fed. This is an open invitation for the market—which doesn’t need much encouragement—to treat all these institutions as too-big-to-fail (TBTF). When the market believes that a firm is TBTF the firm receives cheaper funding because it is perceived as less risky than its smaller competitors, but it also encourages more risk-taking because of reduced market discipline. Thus, while trying to control risk-taking with greater regulation, the Dodd-Frank Act actually increased it.

Third, since this Act’s passage, the staffs of the Fed, OCC, FDIC, SEC, and CFTC have been drafting a plethora of new rules aimed at strengthening government supervision. Most of those have not been put in operational form, and many have not yet even been exposed for public comment. The primary goal of rule-making is to protect society by improving the ability of regulators to control risk-taking, but the uncertainties about policies and costs implicit in this impending regulation have been suppressing economic growth.

In dynamic markets, rules and their enforcement must be dynamic. To control moral hazard, your administration must work to ensure that regulators adapt to changes in the environment that change the effectiveness of regulations. Congress and regulators should be vigilant to make corrections in statutes and regulations when and as their costs begin to outstrip their benefits.

2. Subsidization of Housing Activity: Nearly everyone agrees that breakdowns in our nation’s system of housing finance helped both to precipitate and to deepen the Great Recession. Nevertheless, your administration has yet to define the boundaries of the government’s future role in housing finance or to develop a plan for transferring the assets held by insolvent government-sponsored housing-finance institutions (GSEs) to the private sector in an unguaranteed form. Instead, top officials repeatedly rehash the alternatives of privatizing, liquidating, or recapitalizing these firms without offering a convincing justification for pursuing one of these alternatives rather than another.

A particularly destabilizing feature of federal housing policy has been its predilection for relying on off-budget expenditures and mandates to increase homeownership and homebuilding activity. Off-budget funding of housing programs makes the true costs and benefits of housing programs impossible to measure and evaluate accurately. The programs in question include: the creation of implicitly subsidized mortgage institutions (i.e., Freddie Mac, Fannie Mae, the Federal Home Loan Banks, FHA, and Ginnie Mae) and the rules that govern their lending policies; favorable tax treatment of mortgage interest; lower risk-based capital standards for financial institutions on residential mortgage loans and GSE obligations; and legislation such as the Community Reinvestment Act that seek to expand riskier forms of mortgage lending.

Your administration should work with Congress to end the conservatorships of Fannie and Freddie and to recast politically determined efforts to promote housing as direct and transparent subsidies that could be targeted to explicitly approved recipients (such as low-income homeowners) at known costs that would be subject to regular budgetary review. Then, all other aspects of housing finance would be handled by the private sector.

3. Limits of Safety-Net Protection for the Financial System. During the crisis, bailout policies focused on symptoms rather than causes. Among the many causes of the crisis are explicit and implicit government guarantees and bailout programs that distorted market signals and undermined the effectiveness of private and government supervision. Not accounting properly for the risks and costs these programs impose on taxpayers reinforces incentives for government regulators that foster financial instability in the private sector.

Despite the anti-bailout provisions of the Dodd-Frank Act, in a future crisis authorities are likely to presume (as they did in this one) that financial institutions' problems in rolling over their debts arise from a shortage of market liquidity without investigating the extent to which these problems reflect reasonable doubts about the reliability of the estimates of accounting net worth reported by troubled institutions. Abandoning protocols for using prompt corrective action and bridge banks for resolving insolvent institutions established by the FDIC Improvement Act of 1991, officials undertook a series of ad hoc and short-sighted interventions into the affairs of giant bank and nonbank firms that has greatly expanded the US financial safety net. It is now generally believed that in similarly difficult circumstances the U.S. government will find a way to support most or all giant financial institutions, whatever their charter status or national origin. This might include not only money market funds but exchanges and derivatives clearing organizations located anywhere in the world. Eight central clearing parties have already been designated as "financial market utilities," which gives them emergency access to Fed funding.

Throughout the crisis, the Fed, Treasury and FDIC have reinforced this belief by pursuing unprecedented policies of institutional support and insolvency resolution that delivered hard-to-evaluate forms of bailouts to selected large institutions and their creditors (through direct government funding, asset and debt guarantees, and subsidies to acquirers of distressed institutions).

The expanded resolution authority established by the Dodd-Frank Act makes the avoidance of expensive future bailouts depend squarely on the vigilance, competence, and good intentions of future regulators. Your administration must work to limit the moral hazard and arbitrariness this authority entails. This can be done by formulating clear decision rules that assign accountability for the tax and transfer payments that bailouts produce.

4. Financial-Institution Consolidation and Competition. Expanding the safety net has adversely affected the size distribution, product lines, and locations of financial competitors. Institutions must not be encouraged to make themselves too large, too international, or too interconnected for authorities to fail or liquidate. The precedents established by the dramatic expansion of government protection of important markets and institutions during the crisis incentivize managers of giant institutions to increase their firms' size, complexity, and risk exposure at taxpayers' expense.

Bailout policies followed during the financial crisis have caused the U.S. banking system to become increasingly top-heavy. The post-crisis industry structure shows an unbalanced size distribution which combines a handful of huge institutions with a large but shrinking number of smaller community and regional banks who are struggling to overcome the funding advantage that their larger competitors obtain from implicit guarantees.

As the Great Recession recedes, the government must devise a process for orderly unwinding government protections and offloading risk from the Federal Reserve's greatly expanded balance sheet. Your administration must promote competition and further circumscribe access to bailouts to protect taxpayers, to ensure the efficiency of the financial system, and to enhance market discipline. The Dodd-Frank Act has had the opposite effect. It makes the moral hazard resulting from too-big-to-fail perceptions a more significant issue than ever before

5. Innovative Financial Instruments and Deal-Making Arrangements. Managers of giant institutions know that hiding loss exposures that pass through to the safety net by transacting in ever more complicated and opaque instruments can increase short-term profits and enhance profit-based executive compensation. By simultaneously tolerating declines in accounting transparency from the increased complexity of institutional portfolios and methods of arbitraging away the burden of capital requirements and other prudential measures, supervisors encouraged the underpricing of risk, and the sudden correction of this underpricing triggered the crisis. The crisis punished investors who accepted more risk than they thought they had bargained for, borrowers who overleveraged themselves, citizens who lost their jobs or homes, and taxpayers who are apt to be presented with the bill for the mess.

Regulators and supervisors have a duty to see that risks can be fully understood and fairly priced by each of these groups. To do this requires a reorientation of government regulation, aimed at producing an efficient layering of private and governmental discipline.

To reduce opportunities for forbearance by regulators, this Committee has supported the concepts of the Prompt Corrective Action program (PCA) and Structured Early Intervention and Resolution (SEIR) as specified by the FDIC Improvement Act of 1991 (FDICIA). PCA and SEIR mandate a ladder of increasingly harsh regulatory sanctions. The Committee also favors expanding the information available to regulators and market participants by requiring banks to issue subordinated and convertible debt whose fluctuations in market price would supplement other market and supervisory signals about the financial health of the issuing institution and provide additional protection against safety-net costs.

In view of continuing and partly regulation-induced evolution in financial instruments, the Committee reiterates its recommendation that supervisors be obliged to look for ways to extract additional information about the riskiness of large financial institutions from new financial instruments as they emerge. Supervisors have already proposed to use data on (admittedly thinly traded) credit default swaps (CDS) to assess institutional risk.

A CDS provides insurance against defaults on designated obligations. In fact, taxpayers' stake in a protected institution is functionally equivalent to a CDS. The value of this stake could be priced by the market if equivalent swaps were issued publicly and traded regularly.

Prices of safety-net CDS could help authorities to assess how well capital requirements and other prudential controls were working and would provide fresher and more accurate information on an institution's financial well-being than accounting statements or yields on observed infrequently traded debt.

Your administration should work with regulators to see that protected banks, bank holding companies, money market funds, exchanges, and derivatives clearing organizations make more transparent the risks they impose not only on investors, creditors, and counterparties, but also those that pass through to taxpayers. A good start would be to require regulators to develop ways of measuring the value of the risks that these firms shift onto the safety net. Reports could be prepared and self-reported on a regular basis by any institution designated as systemically important. Of course, the information provided by these measures would have to be routinely reviewed and tested by regulatory personnel. Such information would lead to an improved understanding of the relationship between an institution's risk exposure and its profitability, and provide guidance to regulators seeking to lessen the incentive for protected firms to shift risk onto the safety net.