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Financial Crises and Policy Responses

A MARKET-BASED VIEW FROM THE SHADOW FINANCIAL REGULATORY COMMITTEE, 1986–2015

ROBERT LITAN

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Preface

This is an unusual book. It is the history of both an organization—the Shadow Financial Regulatory Committee—and an epoch in the history of finance, mostly in the United States: 1986 to 2015.

As most readers will know, these years have been often turbulent, marked by financial crises originating from different sources and evoking different kinds of policy responses. But for the most part, the reactions have moved in one direction: more rules, more legal prescriptions, and more prohibitions aimed at preventing the crisis that just occurred.

Yet as most of us also know, every crisis is different, and rules aimed to prevent the last one—like military technologies deployed to fight the last war—often prove to not be up to the task when the next crisis comes along. But still, after each crisis, the rule-making cycle continues.

In large part, this pattern flows from false choices that policymakers offer and the media report about the causes of and solutions to financial crises: either write more rules, or take them away and rely on the market alone to discipline bad actors and behavior. Rarely is the right answer at the extremes or so black and white.

The reality is that both markets and governments alone often fail to produce ideal outcomes, and policy must take account of both facts. This reality helped motivate the formation of the US Shadow Financial Regulatory Committee (the "Shadow Committee," "Committee," or "SFRC"), whose activities, as well as the financial history to which they apply, are the subject of this book.

The SFRC was an outgrowth of a 1980s task force on the future of American banking, comprised of five leading US academic scholars on the banking industry and convened by the American Bankers Association. The task force's work was later published as a book in 1986.[1] The scholars were George Benston (University of Rochester), Robert Eisenbeis (University of North Carolina), Paul Horvitz (University of Houston), Ed Kane (Ohio State), and George Kaufman (Loyola University of Chicago). The five had previously known each other well and had generally similar views about public policy's role toward banks: namely, that market principles should guide public policy, as long as the outcomes enhance economic welfare.

By 1986, the five colleagues had built on their professional and personal relationships and decided to follow in the steps of the Shadow Open Market Committee, which was formed earlier by Professors Karl Brunner and Alan Meltzer to provide a regular independent assessment of the Federal Reserve's monetary policies. The five financial economists invited Meltzer, along with other banking experts from the private sector, to join the new Shadow Financial Regulatory Committee: Richard Aspinwall (Chase Manhattan); Lawrence Connell, a private banking attorney; academic banking experts Franklin Edwards (Columbia University) and Kenneth Scott (Stanford University and previously general counsel of the Federal Home Loan Bank Board); and John D. Hawke, one of the nation's leading banking lawyers, who had previously served as general counsel to the Federal Reserve and later went on to become undersecretary of the treasury for domestic finance and then comptroller of the currency in the Clinton administration. Connell and Kaufman served as the Shadow Committee's first co-chairs. Connell later resigned, and the Committee has had other co-chairs serve alongside Kaufman, who remained in the co-chair's post throughout the Committee's history.

The Committee's membership turned over from time to time throughout its three-decade life. Although most members came from academia, many had private-sector and policymaking experience, which helped inject political realism into the

Committee's discussions and formal statements. Multiple benefactors funded the Committee at various points, including the Mellon Foundation, the Richard Scaife Foundation, the Smith Richardson Foundation, and the American Enterprise Institute, to which the Shadow Committee members have been and continue to be grateful.

The SFRC operated in much the same manner as its monetary policy counterpart, the Shadow Open Market Committee. The SFRC convened quarterly in Washington, DC, meeting for a full day (and oftentimes well into the early evening) on Sunday and then Monday morning. It usually crafted several policy statements, which were released at a Monday luncheon press conference, attended mainly by the financial media and other interested individuals. The Sunday meetings generally also included presentations by an outside guest, most frequently a current financial government official, who spoke off-the-record and typically provided useful background information.

The Sunday meetings were intense, lively, and informative for the members, and hopefully the statements they produced were useful for policymakers and the wider public. The Committee members, although they shared a broad philosophical commitment to market-based finance, often did not initially agree on what stance to take in particular statements or have preconceived notions about them. The discussions at the meetings thus provided an important educational function for the Committee's members, which in my view, helped explain why the Committee lasted as long as it did, given the quarterly weekend time commitments membership demanded. As readers will see, the SFRC's views generally were consistent over time, but in a few instances, the members refined what they had said before.

The SFRC viewed its main mission as helping policymakers, the media, and the general public understand that finance (and other sectors of the economy, for that matter) works best when it has simple, market-based guardrails: not high regulatory walls, but certain basic rules to keep financial markets and institutions from wrecking the entire economy. Those guardrails, in turn, should either mimic market behavior or have market-like features.

For American readers who are football fans, a football analogy may be useful here. As with any organized game, someone sets the rules of play, specifies the field size, and has referees to enforce the rules. Applied to the banking industry, in which banks are owned by private shareholders, the "game" is competition among the banks and other financial institutions; Congress and the executive branch set the rules, sometimes modified or rejected by the courts; and regulators (and again, sometimes the courts) are the "referees" who enforce the rules. Contrast this three-part system with countries where the government owns banks or other types of financial institutions. To American football fans, this would be like the referees owning and running the teams. That is not our model for finance.

Whatever analogy one may choose, the Shadow members believed that, at a minimum, they could raise the quality of public debate on financial policy issues. Ideally, they wanted to influence the content of those policies as well, and in one notable area, they actually did.

The Committee applied its principles to multiple financial policy challenges over the course of three decades, issuing more than 300 policy statements on a wide variety of topics relating to financial policy. This book distills and organizes the key messages in most (but not all) of these statements and in the process provides a kind of Cliffs Notes summary of finance during the 1986–2015 period, through the lens of financial experts with a strong commitment to and preference for market-based policies.

The chapters in the book are ordered by topic and are roughly, but not strictly, chronological. By the end, I claim that had policymakers consistently followed some of the basic principles set forth in the Committee's statements, the US financial sector—and the financial sectors of other countries—would have been much more stable. I know the members of the Shadow Committee through the years share this view. Readers will make their own judgments.

Of course, there is no way to convincingly show which of the many ideas and policies outlined in the SFRC's statements made their way into policy—with one notable exception: the concept of structured early intervention and resolution (SEIR) or prompt corrective action, which the Committee urged Congress and banking supervisors in particular to follow. And, as readers will learn, for more than a decade, that was what they did.

But then, at some point in the run-up to the crisis, regulators abandoned this approach; whether intentionally or unintentionally, it is not clear. In particular, large banks that had formed supposedly independent structured investment vehicles (the infamous SIVs) turned out to be dependent on their creators, and when they were absorbed back into their "mother ships," many of the largest ships sank or came close to doing so, after some of their largest investments in securities backed by subprime mortgages (a term that by now is so well understood it does not need to be explained) turned sour.

By the fall of 2008, it was too late for SEIR to "work" because the institutions to which it was meant to apply already were essentially insolvent. The Federal Reserve, the Treasury Department, and federal banking regulators stepped in to prevent creditors of the largest institutions from suffering losses—either by compelling their merger with healthier financial giants, generally with explicit or implicit assistance, or in the case of AIG, investing in them directly—to protect the financial system as a whole from collapsing. The SFRC members were not happy about these developments—nor were policymakers and voters in both political parties—and debate continues to this day over how necessary these extraordinary interventions were.

In any event, Congress adopted and President Barack Obama signed into law the Dodd-Frank Act of 2010 to prevent this chain of events from happening again. The SFRC was critical of many features of this act. Readers should be aware that I personally took a less pessimistic view in some of my writings at the time the act was being considered and shortly after it was passed, although I too was critical of some parts of the act, notably the so-called Volcker Rule.

Since then, as I have witnessed the complexity of some of the rules implementing the act, I have become less enthusiastic about the bill as a whole. However, I still strongly support those portions of the act that require stronger capital standards for banks (since largely accomplished); additional layers of capital for systemically important financial institutions (SIFIs), a concept rejected by the SFRC; and mandates that standardized financial derivatives traded over-the-counter (not on formal exchanges) be centrally cleared and backed by adequate margin or collateral, a position generally in line with the thinking and statements of the SFRC.

I mention all this in the preface not only to let readers know my own personal views and biases but also because for more than a decade before the 2008 financial crisis, and for a few years after it, I was privileged to be a member of the SFRC and, for a time, to serve as its co-chair. Despite my own evolving views of Dodd-Frank, and differences on some aspects of the act between my own views and those of the SFRC, the Committee members asked me to write this history of their activities, which I have done by placing the Committee's statements in the larger context of the financial history of the three decades of the Committee's life.

I was honored by this invitation and opportunity to look back on this important period of financial activity, both in the United States and abroad—because, as readers will learn, the US Shadow Committee became a role model for the formation of similar Shadow Committees formed in five other parts of the world. I hope readers with an interest in this history and the important policy issues it raised will find this book at least as half as stimulating (hopefully more!) as it has been for me to write it.

One additional thought: in reviewing all the Shadow Committee's statements through the years, I was struck, and I am guessing many readers will be, by how the vast majority of the statements were critical of government policies. To be sure, there were some exceptions when the Committee praised certain legislative or regulatory initiatives. This tilt toward negativity may strike some readers as whining, but in looking back I take a different view: that it reflects the degree to which policymakers in both political parties and under different administrations have not been as willing, at least so far, to embrace fully and consistently market-based ways of organizing and supervising financial markets and institutions, as the Shadow Committee has consistently recommended, although there are some recent halting signs that this is changing.

Some readers may respond, "Of course, that is because markets have repeatedly failed in finance, so we need 'tough cops' on the beat and a battery of regulations to rein in wild financiers." Market purists, on the other hand, will just wring their hands.

I take a different view. Taken as a whole, the Shadow statements do not advocate a totally hands-off approach to regulation of financial institutions and markets. Rather, they occupy more of a middle ground, one that urges the incorporation of *market-based principles* into regulation, much as the trading of emission permits in lieu of command-and-control regulation has been partially embraced in environmental regulation. Hopefully, this is the main lesson that careful readers, including policymakers, take away from this book and apply to future financial policy challenges.

The views expressed in this book are my own and are not meant to be those of the many members who served on the Shadow Committee over the years, although many of these individuals—especially Frank Edwards, Bob Eisenbeis, George Kaufman, Ed Kane, and Chester Spatt—provided very useful comments and feedback on earlier drafts of the book, for which I am deeply grateful. I also want to thank Kevin Hassett, director of research for domestic policy at AEI, for supporting this project and the publication of this book.

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November 2017

Notes

1. George J. Benston et al., *Perspectives on Safe and Sound Banking: Past, Present, and Future* (Cambridge, MA: MIT Press, 1986).

I. Financial Crises and Challenges: The Origins of the Shadow Financial Regulatory Committee

Finance is an important but often not a quiet business. So it has been during the last 500 years or so since the key institutions of finance were developed.

Financial institutions and markets are important because when they work well, they vastly improve the performance of the "real economy"—the production and consumption of physical goods, services, and more recently, virtual goods and services. In a world where goods and services can only be traded by barter, little would and did get done. If you wanted grain, you might only be willing to accept seeds or plows, but little or nothing else, and vice versa for suppliers of seeds and plows. A world of barter means that wants must be perfectly matched by type, and often by time and place, for trade to take place. It is little wonder then that for much of human history, masses of people lived in conditions that today we would characterize as poverty.

The invention of money—and later of institutions such as banks to hold it and move it around—permitted many more trades and thus the specialization of labor, which Adam Smith and a long line of economists since him have singled out as crucial for promoting economic growth. The same is true for other kinds of financial institutions: insurance, which spread risk, and later, securities firms, which helped firms issue bonds and stocks to finance their growth. Growing firms, in turn, led to growing economies.

But finance has also been the source of much turbulence, not only among the institutions in the business but also for the real economies built around them. For banks, the source of both their weakness and strength is leverage: the ability to borrow, mostly through deposits of customers, large multiples of capital invested by shareholders. The upside of leverage is that substantial borrowing enables banks to lend more than if they had to finance loans out of their shareholder's funds, which facilitates economic expansion. The downside of leverage is that even relatively small percentage losses in a bank's loan portfolio can severely deplete or even wipe out a bank's thin layer of capital.

If too many banks fail, or even seem to be failing, panicky depositors can quickly withdraw their funds, triggering a domino-like collapse of many banks, as happened during the Great Depression. The government's guarantee of deposits (technically funded in the first resort through insurance premiums paid by banks themselves) introduced in the 1930s has since stabilized the banking industry, with some notable exceptions discussed extensively in this book: in the 1980s when the largest banks' solvency was tested severely by potential defaults by sovereign country borrowers from the developing world, as it was then called, and most recently during the financial crisis of September 2008, when the nation's largest banks did not trust the financial soundness of others enough even to lend them money overnight (in the so-called fed funds market).

The largest firms in the business of underwriting (selling) securities also are structured like banks—although since the 2008 financial crisis, two of the leading investment banks (Goldman Sachs and Morgan Stanley) have been absorbed into or become bank-like enterprises—in that they are leveraged on relatively thin layers of capital with large amounts of deposit-like repurchase agreements (sales of Treasury securities with a promise, usually the next day, to buy them back at a slightly higher price). Even though these liabilities are backed by collateral, they are subject to a similar kind of "run risk" associated with deposits: if investors lack confidence in the firm's financial future, they will not roll over their repos, causing the firms to collapse.

It remains a matter of dispute whether the failure of a large securities firm would significantly damage the economy in much the same way as a large bank failure.

Nonetheless, it remains a matter of dispute whether the failure of a large securities firm would significantly damage the economy in much the same way as a large bank failure. As proof, debate continues to this day whether federal officials should have bailed out the creditors of Lehman in September 2008—as they effectively did through the arranged marriage and federal backing of J.P. Morgan's purchase of Bear Stearns earlier that same year—rather than let Lehman go bankrupt, which is what happened.

Capital markets—specifically stock markets—have well-documented linkages to the real economy, although economists do not widely believe that sudden changes in stock prices have the same potentially sudden impacts associated with bank deposit runs. Stock price increases typically occur incrementally over long periods of time and, by enhancing investors' wealth, eventually enhance their consumption, with positive effects on output and incomes—although by how much continues to be a matter of dispute among economists. Stock price declines can be much sharper and concentrated over much shorter periods of time, but their full negative effects on the real economy are typically stretched over much longer periods. Many economists believe, for example, that the sharp contraction in stock prices in 2008–09 during the financial crisis not only contributed to the deep recession but also made many consumers nervous about spending, slowing the ensuing recovery.

Insurance companies also can run into financial trouble, but the knock-on or systemic risks associated with the failure of even a large insurer are also generally viewed to be less dangerous than a large bank failure. Insurers of property and even lives tend to fail (AIG being a notable exception, as discussed later in this book) because some common event or catastrophe triggers claims that the insurers had not expected to pay. But even in these circumstances, the collapses take time, and so does any economic harm caused to policyholders—which is also limited because state guaranty funds, financed by after-the-fact assessments on surviving insurers, pay off claims on bankrupt insurers, generally up to $300,000.

Many life insurers also sell annuities or other types of investment contracts. If one or more of these larger institutions fail, it could trigger a loss of confidence in other similar insurers, inducing their customers to ask for their money back. Any such run would be analogous to a bank deposit run, but with a big difference: the typical annuity or life investment contract has a waiting period, typically at least six months, which limits the systemic risk if the insurer cannot honor its contracts. Even then, these contracts are backed by state guaranty funds up to some limit.

Running through the different ways in which finance can fail and potentially infect the real economy is of greater interest now than it would have been when the Shadow Financial Regulatory Committee was formed in 1986. (For a more detailed history, see the preface.) It has been less than a decade since the great financial crisis of 2008 rocked not only the banking system but also the two housing finance giants that were created and implicitly backed by the federal government (Fannie Mae and Freddie Mac) and the nation's largest insurer, AIG. That being said, AIG's troubles were caused by nontraditional insurance activities: losses on insurance of loans, or credit default swaps, and losses arising from the purchase of high-risk mortgage securities from the proceeds of its unusual securities lending program.

Nonetheless, it is useful to review how finance evolved up until the 2008 crisis and with the much enhanced system of financial regulation that has followed. I do so in this book through the lens of a unique organization, the SFRC, which consistently offered advice to policymakers on how market forces or market-like regulation might have averted or at least minimized the consequences of the financial calamities that followed. Although the Shadow Committee spent much of its first two decades on banking and related issues, it expanded its scope and expertise into other financial policy arenas as events worthy of comment unfolded.

Over time, financial experts in other countries copied the US Shadow Committee model, creating five other "Shadows." These committees eventually held 10 joint meetings, issuing joint reports and even a book on the common financial policy issues that confronted these countries after the financial crisis. (Unless otherwise indicated, all references to the "Shadow Committee" in this book are to the US Committee.)

You will learn all this, and hopefully more, as you read many (ideally all!) of the following chapters. My hope is that readers from both sides of the political aisle—including the independents in the middle—will come away with a new or strengthened appreciation of why "let the market rip" or "regulate financiers as if they were potential crooks" was and always will be a false choice. There is a sensible middle, but one consistent with the market principles on which the US economy was founded and still largely operates.

With the exception of the next chapter, which provides a very brief guide to the key events and developments in finance over the past 30 years, each substantive chapter begins with a background description of the financial events at the time and the key policy issues they raised. I then summarize some (but not all) of the statements the Shadow Committee issued on these questions. I conclude each chapter with a brief forward-looking statement, either about how the events and relevant policies actually turned out or what policy issues related to those discussed in the chapter remain to be addressed.

In several instances, policymakers actually followed policies consistent with what the Committee recommended, and these are clearly highlighted in the book. But in many other instances, this was not the case, or it is impossible to know whether and to what extent the Shadow Committee policy statements affected key policy decisions.[1]

One notational detail: I refer to all US SFRC statements by their number in parentheses (such as 79 or 245) and the International or Joint Shadow Committee Statements by a similar notation (I1, I2, and so on), but without giving each statement's full title. This information is available in the appendix, which lists all Shadow Committee statements, both US and Joint.

By the end, readers should be ready for my ultimate purpose: to offer what I hope is informed speculation on how the financial world and its related real economies would have performed had policymakers, more or less, followed the recommendations the US and other Shadow Committees outlined through the years. To preview my bottom line: the financial sectors of these economies would have been safer, less turbulent, and more efficient. Correspondingly, the economies themselves would have grown more rapidly and been less volatile.

Whether you come to share all or even a part of these conclusions, I hope you enjoy the journey you are now about to take into the worlds of the Shadow Committee and the financial arena on which it focused.

Notes

1. It is clearer that the Shadow's statements had at least some effect on academic thinking, which is not surprising given the academic reputations of many of the Committee's members. Throughout its history, Shadow members were asked to arrange and sponsor sessions on financial policy issues at a variety of academic and professional meetings.

II. A Brief 30-Year History of Finance

Many readers may not be old enough to remember, even in a very cursory way, all the key events and developments in finance over the past three decades that are covered in this book and the Shadow Committee's statements. Table 1 is a quick summary.

Table 1. Financial Highlights by Decade

1980s	
1980–82	Major recession, the "first" savings and loan crisis
1980	Depository Institutions Deregulation and Monetary Control Act (elimination of interest-rate ceilings on bank and thrift institution deposit accounts)
1982	Garn–St Germain Act (partial deregulation of thrift institution activities; allowing consumer and commercial loans, up to a limit)
1986	US-UK Bank Capital Accord; Shadow Financial Regulatory Committee launched
1987	Stock market crash in October
1988	Basel I capital standards implemented
1989	Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA); Funding for savings and loan (S&L) Cleanup; Formation of the Resolution Trust Corporation
1990s	
1991	Federal Deposit Insurance Corporation Improvement Act (FDICIA); Implementation of structured early intervention and resolution (SEIR)
1992	Recession
1994	Mexican debt crisis; Riegle-Neal Interstate Branching and Banking Act
1995	Sunset of the Resolution Trust Corporation
1997	Asian financial crisis
1998	Russian financial crisis; Long-Term Capital Management LP (LTCM) crisis and Fed-orchestrated bailout by its creditors
1999	Gramm-Leach-Bliley Act (GLB or GLBA)
2000s	
2000	Bursting of the internet stock bubble
2001–02	Major public company accounting scandals

(contintued on the next page)

Table 1. Financial Highlights by Decade (continued)

2002	Sarbanes-Oxley Act (SOX)
2007	Attempt to rescue structured investment vehicles (SIVs); First clear signs of imminent financial crisis
2008	Partial implementation of Basel II bank capital standards; Onset of financial crisis; Failures and rescues of Bear Stearns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual, and Wachovia; Authorization of the Troubled Asset Relief Program and various Fed emergency lending programs
2009	More Fed lending; Introduction of Bank Stress Tests; Basel III
2010s	
2010	Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

Source: Author.

Table 1 encompasses several financial crises—the 1987 stock market crash, LTCM, and the 2008 financial crisis—and various pieces of legislation or rules that either responded to these crises or changed the financial landscape, largely ratifying and formalizing events or trends that had been happening before (for example, nationwide banking in 1994 and broader activity powers for banking and financial organizations in 1999).

III. The S&L Crises of the 1980s

The 1980s were an up-and-down decade. The "down," of course, was the recession of 1980–82, at that time the deepest recession since the Depression, coupled with double-digit rates of inflation. These were the worst two years, as measured by the misery index (the peak unemployment of nearly 11 percent in 1982 plus the inflation rate in that year of 10 percent) of the post-Depression era.

The "up" part lasted for the next eight years, as the 1981 Reagan tax cuts stimulated demand, even accounting for tax increases in subsequent years of the Reagan presidency, which brought unemployment down to below 6 percent at the decade's end. Meanwhile, the Federal Reserve's tight money policies, initiated by Paul Volcker and later continued by Alan Greenspan, tamed inflation, bringing it down to below 4 percent by 1989.

The US and global economies nonetheless were marked throughout the decade by large fluctuations in interest rates and oil prices, which indirectly contributed to the nation's first major financial crisis since the Depression. However, unlike the immediacy of the crisis that slammed the economy almost three decades later, these crises had long fuses—indeed, financial policymakers deliberately lengthened the fuses, hoping that economic events would intervene to keep them from being lit or burning out of control.

In this they succeeded, but ultimately at great cost (at least for that time) to US taxpayers in the case of the first of these crises: the one centered on savings and loans (S&L), or specialized depository institutions with charters originally confining them to lend their deposits solely for residential mortgages. Readers old enough to remember will know that Hollywood made these institutions famous decades earlier in the classic movie *It's A Wonderful Life*. Chapter 4 deals with a different, but related, decade-long crisis among US banks.

Actually, the 1980s saw two S&L crises, which had very different causes, although because of policy failures, the first one led to the second. The initial crisis grew out of the structure of the balance sheet of S&Ls—assets held in long-term residential mortgages mostly extended at fixed interest rates, which were funded by deposits that by law (under the so-called Regulation Q) could pay depositors annual interest of no more than 5.5 percent (one-quarter point higher than bank depositors). When short-term interest rates soared in the late 1970s, largely in response to a large run-up in oil prices triggered by the Iranian Revolution, and went even higher to 18 percent at their peak in the early 1980s under the tight money policy of the Volcker-led Fed, many depositors at thrifts and banks transferred their money to money market funds (MMFs), which held large amounts of much higher interest-bearing short-term Treasury securities. To keep the thrift and banking industries from losing their deposits, thereby triggering a potentially devastating financial and economic crisis, Congress lifted the Regulation Q interest-rate ceilings on bank and thrift accounts in late 1980 so depository institutions could effectively compete with MMFs.

The 1980 deregulation bill prevented that possible collapse by putting banks, thrifts, and MMFs on a level playing field, but the legislation could not hide the true nature of the thrifts' massive problem: with thrifts paying depositors much more than the 6–8 percent rates on the residential mortgages on their books, essentially the entire industry was insolvent on a *market-value* basis. This is because the market values of thrifts' assets fell far short of the newly deregulated value of their deposit liabilities.

Policymakers at the time, however, had no stomach for mark-to-market accounting. Not only did they not want to put essentially the entire thrift industry out of business, but also the deposit insurance fund backing thrift deposits had nowhere near the funds that would have been needed—perhaps $100 billion or more—if all insolvent thrifts had then been liquidated. Additionally, in that difficult environment, thrift institutions, even if their managements had wanted to, probably could not have raised sufficient new capital (heavily diluting or wiping out the old capital) to have filled the holes in their balance sheets left by their market-value losses. Likewise, thrifts that were organized as "mutual organizations," owned by their depositors, could not count on depositors plumping up substantial new monies to make up for these thrifts' losses.

Neither Congress nor the industry was in the mood to be patient.

So it was not unreasonable for policymakers in this initial thrift crisis to have engaged in what later came to be called regulatory forbearance: essentially looking the other way and waiting for interest rates to return to more normal levels so that the market value of thrift assets, mainly their fixed-rate residential mortgages, would again exceed the value of thrifts' deposits. But neither Congress nor the industry was in the mood to be patient. They both wanted thrifts to gain additional ways to make money so they could return to profitability—and solvency—more quickly. Accordingly, Congress enacted the Garn–St Germain Depository Institutions Act of 1982, broadening thrifts' lending powers beyond residential mortgages to include nonmortgage loans to consumers and loans to commercial real estate developers.

In principle, the new lending authorities could have helped matters, which is why the Shadow Committee supported the 1982 bill (10) and opposed federal regulators' efforts to limit what state-chartered thrifts could do. After all, thrifts got into trouble in the first place partly because they were unable to diversify their assets beyond long-term fixed-rate residential mortgages. But this interest-rate-related forbearance policy made sense only if regulators had also then tightly overseen the thrifts' future lending activities, because once shareholders no longer had any real skin in the game, they had every reason to permit thrift executives to make risky loans or "go for broke" in case interest rates did not fall as fast as managers and shareholders wanted.

As it turned out, interest rates eventually did reverse course in response to the Fed's anti-inflation policies, which vindicated the regulatory policy of waiting things out. The problem was that, at the same time, too many thrifts took advantage of their new powers to "gamble for resurrection" and were not stopped from doing so by federal and (typically under-resourced) state supervisors. In most cases this gambling took the form of risky lending, while in other cases (no good study has quantified how often), managers of under-the-water thrifts resorted to outright fraud. Making matters worse was a collapse of world oil prices in the middle of the decade, which wiped out the equity in many homes and office buildings that thrifts in "oil patch" states such as Texas had financed, triggering major losses in these thrifts' loan portfolios.

By the time the Shadow Committee had formed in 1986, the thrift industry was thus well into its second crisis of the decade, but this time the main cause was irresponsible lending. Had the Reagan administration then gone to Congress and asked for sufficient funds to enable the thrift deposit insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), and the industry's federal regulator, the Federal Home Loan Bank Board (FHLBB), to shut down or assist the merger of all thrifts that were then insolvent, even on a book-value basis, the cost would have been far lower (perhaps as low at $15 billion). That is not what happened, however, perhaps because of wishful thinking by regulators and many in Congress that the problem again was temporary and eventually would go away.

It did not. Bad loans once made ordinarily do not later become good. It took a new administration, that of President George H. W. Bush, to ask Congress for the funds to close down or force the merger of hundreds of failed thrifts. By this time, the cost of "resolving" the thrift crisis had ballooned north of $100 billion (a lot of money in those days), exceeding the administration's initial estimate of $90 billion, as the Shadow Committee pointed out in February 1989 when the new Bush administration proposed the plan (3).

The cleanup job would be finished several years later by a new government agency, the Resolution Trust Corporation (RTC), which was created to sell off the underperforming assets of failed thrifts. Amazingly for Washington, the RTC actually was shut down in 1995 after the last assets from failed thrifts had been sold.

Shadow Statements

The SFRC issued numerous statements in 1986–89 as the second thrift crisis continued to get worse. It first objected in June 1986 to regulatory forbearance that permitted "zombie thrifts"—those with market values less than zero—to remain in business (8).

The Committee also urged Congress to adopt a legislative proposal then under consideration that would have permitted out-of-state banks or thrifts to take over failing depositories as a way of reducing the need for funds from the deposit insurance funds (9). This idea was viewed as radical at the time when neither banks nor thrifts were permitted to open branches in other states and out-of-state holding company acquisitions of depositories were limited, depending on state law.

In November 1986 the Committee issued the first of several calls for substantial additional funding for the FSLIC (8, 16, 28).[1] All the while, the Committee criticized the slow pace of resolving failed thrifts, which of course was dictated by the shortage of funds in the FSLIC to do the job (22).

In May 1989, the Committee applauded Congress' willingness to devote $90 billion to resolving failed thrifts but criticized the weakness of the proposed new capital standard for thrifts (just 3 percent of assets), the limits on thrifts' ability to diversify their assets, and other aspects of the pending legislation that were designed to prevent future crises (43). After the thrift crisis was finally addressed in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Committee began urging the RTC, the body charged with disposing of the assets of failed thrifts, to do the job as quickly as possible, otherwise running the risk of watching the assets deteriorate in value to the detriment of taxpayers who were footing the bill (48).

Bad loans once made ordinarily do not later become good.

In fact, real estate prices fell in parts of the country, especially in the Northeast in the years immediately after the enactment of FIRREA, but recovered in the 1990s. The RTC effectively waited out this real estate price cycle and did not complete its mission until 1995. Whether it minimized taxpayer losses in the process is something that probably can never be known.

At a more technical level, the Committee voiced concerns about how the RTC initially did its job: selling off the failed thrifts, with the RTC providing to acquirers the cash to fill the "negative equity" holes in their balance sheets, coupled with a "put" clause that enabled acquirers to foist off risky assets they did not want onto the RTC at above-market prices. The Committee argued that it was better to have such difficult-to-value assets in the hands of private actors than in the hands of the government where they tended to end up (55), an argument the Committee believed was strengthened as real estate prices continued to decline (60).

Along the way, the Committee issued statements that endorsed ways of encouraging thrifts to bolster their capital cushions. One such approach was the then-controversial conversion of mutually owned thrifts to stock-funded organizations, which the Committee endorsed as long as the Federal Deposit Insurance Corporation, as successor to the thrift deposit insurance fund and which all along had assumed the risk of loss in the event thrifts failed, shared in the benefits of the conversion (104).

Where We Are Now

It has now been more than two decades since the thrift crisis was addressed. In the interim, of course, much has happened, including a financial crisis in 2008 that nearly brought the nation's financial system and economy to its knees—a topic about which I have much more to say in later chapters.

Putting aside that crisis, there has been a trend since the thrift crises of the 1980s, perhaps even before then, toward consolidating the nation's depository institutions—banks and thrifts alike—into fewer numbers. This was inevitable, independent of the crises, and pushed along by the Riegle-Neal Interstate Banking and Branching Act of 1994, discussed in Chapter 7.

As for savings institutions in particular, their numbers are down dramatically, from about 4,000 in the late 1970s to fewer than 900. Those institutions are now overseen by a single regulator, since the Dodd-Frank Act of 2010—also discussed in later chapters—consolidated the thrift industry's former separate regulator, the Office of Thrift Supervision (formerly the FHLBB), into the comptroller of the currency, the federal bank regulator.

At the time, the thrift crises of the 1980s seemed unprecedented and devastating. That is how I recall that period. Little did I or anyone else know that a future financial crisis was waiting—roughly two decades hence—that would be far more expensive and threaten the economic welfare of all Americans and residents of many other countries worldwide.

Notes

1. The Committee also opposed the sale of $10 billion in bonds in 1987 to help recapitalize the FSLIC. Because the bonds were not guaranteed by the federal government, they carried a 1 percentage point premium relative to Treasury bonds, thereby imposing an unnecessary additional cost on taxpayers, who the Committee predicted would have to bear the full cost of closing or resolving failed thrifts (20).

IV. The Banking Crises of the 1980s and Policy Responses

Savings and loans were not the only type of financial institution in trouble in the 1980s. The solvency of the nation's largest commercial banks—then commonly called the money center banks—was in question through much of the decade. The main reason was that each of them had loaned heavily, although in different amounts, to sovereign governments and large businesses in less-developed countries (LDCs), mainly in Latin America, which needed funds to pay the high cost of imported oil. Even though oil prices had plummeted by the middle of the decade, these governments were politically incapable of sufficient belt-tightening to service their past debts, casting a long shadow over the financial viability of their lenders.

Eventually, the LDC debt crisis was worked out by the banks and their lenders, with a guiding hand from the US government. None of the major money center banks failed, except for Continental Illinois in 1984 (an unusual money center headquartered in Chicago in a "unit" banking state, which remarkably limited banks back then to a single office), and that was largely because of mismanaged domestic loans, many of them oil related, that turned sour. As with savings and loans, regulators looked the other way throughout the LDC crisis, ignoring the banks' negative net worth based on the market value of their loans and thus keeping them in business, waiting so they could earn enough money on new business to earn their way back to solvency, which most of them eventually did.

However, US regulators were so shaken by the specter of a broad banking collapse that by the mid-1980s they launched a process to strengthen all banks' capital cushions—their ratios of shareholders' capital to their assets, eventually including their off-balance-sheet liabilities—but in a way that did not seem to penalize US-based banks in international financial markets. The "solution" to these twin problems—safety and soundness and ensuring a level playing field—was to coordinate, and ideally harmonize, any new bank capital rules with those of other countries.

The Federal Reserve Board first reached an accord in 1986 with its counterpart, the Bank of England in the United Kingdom. That agreement laid out a new approach to regulating bank capital, which has lasted to this day: instead of simply regulating a bank's leverage (the ratio of its capital to its assets and its off-balance-sheet exposures), the US-UK accord defined a new denominator based on risk-weighted assets, with different types of assets weighted differently, although arbitrarily.

Government securities were assigned a zero-risk weight, meaning no capital was required to back them, regardless of the securities' maturities. At the other extreme, most loans were assigned a 100 percent risk weight and thus treated no differently than under the standard leverage ratio.

Risk weighting became the central feature of the first truly international set of capital standards, the Basel Accord, adopted two years later, in 1998, by the Basel Committee on Banking and Supervision, a committee of central-bank representatives from developed economies. That committee had been meeting since the mid-1970s after the failure of a German bank, Herstatt, had rocked confidence in international banks generally, but over the next decade, the Basel Committee did no more than act as a clearinghouse of best supervisory practices.

That changed after the US-UK capital accord induced the Basel Committee to adopt its first formal capital rule, Basel I, as it has come to be known. The Basel Committee would update those standards twice over the next two decades. The Shadow Committee would issue multiple comments over this period (and longer) on all these efforts.

Basel I and its successors essentially were the international equivalents of model acts that various legal bodies have drafted on various other legal subjects for states within the United States. The Basel standards, like the model acts, were not self-implementing but had to be adopted in some form by the 12 countries represented on the Basel Committee. The standards also were meant to apply to only internationally active banks, although US regulators took the idea further and applied it to all US banks. In 1991, after the US experienced yet another banking crisis, Congress required US bank regulators to add a traditional leverage ratio as a backstop to the Basel standard.

Most importantly for the Shadow Committee and readers of this book, the 1991 legislation, formally known as the Federal Deposit Insurance Corporation Improvement Act (FDICIA), also adopted structured early intervention and resolution (SEIR) or prompt corrective action, requiring regulators to apply progressively stiffer sanctions as a bank's reported capital-to-asset ratio declined.[1] Ultimately, SEIR authorized regulators to take over a weak bank *before* it actually became insolvent, the notion being that regulators ideally could prevent any loss to the bank deposit insurance fund if they caught a troubled bank just before it fell into insolvency.

In reality, that rarely happened, because by the time a bank's reported capital had fallen to such a low level, 2 percent of assets, it was in reality already insolvent because the market values of its assets almost surely had fallen below their historical costs, or "book values." The early takeover authorization was designed with this tendency in mind and, if used, would at least help minimize losses imposed by failed banks on the insurance fund.

The Shadow Committee very much identified with and embraced SEIR because it was largely developed by two of its members, George Benston and George Kauffman, in their academic writings in the 1980s. The full Shadow Committee endorsed the idea in December 1988 (37, revised in 41) and frequently urged its strict application, not only to banks but also to thrifts and even credit unions, whose "common bond" membership limitation and tax-exempt status the Committee opposed (146). In 2000, the American Enterprise Institute published an entire volume, *Reforming Bank Regulation*, which traced the history of bank capital regulation and then advanced in detail the SEIR proposal, coupled with the Shadow Committee's longtime suggestion that larger banking organizations be required to back a certain percentage of their assets with uninsured long-term subordinated debt (160, 168).

SEIR was motivated not only by the highly publicized troubles of the nation's largest banks but also by the mounting numbers during the 1980s of high-cost failures of smaller banks, due to their delayed resolution. Banks ran into trouble for various reasons, among them an uneven economic recovery across the country, the oil price collapse in the 1980s that had also hit savings and loans in the oil patch (discussed in Chapter 3), and state and national banking laws that inhibited banks from expanding beyond state (and sometimes county) lines and thus diversifying both the sources of their deposits and the loans they could make.

By the end of decade, a larger banking crisis was triggered by a drop in real estate prices, concentrated mainly in the Northeast, which was severe enough to bring down the Bank of New England, one of the region's largest banks. Coupled with other bank failures, concerns arose by the beginning of the 1990s about the sufficiency of the reserves in the bank insurance deposit fund to pay for bank failures that had occurred and that were feared in the near future. These fears also prompted Congress to enact FDICIA, with its mandates of bank capital regulation and SEIR, topics discussed in greater detail in the next chapter.

Shadow Statements

The first Committee statement issued in 1986 dealt with the ongoing money center banks' LDC debt crisis (1). The statement dealt specifically with the Baker Plan, named after Secretary of the Treasury James Baker, which called on the large banks to lend another $29 billion to debtors in 15 countries. The Committee opposed the plan because it effectively amounted to the US government arm-twisting the banks, rather than leaving the banks and the debtors themselves to handle any debt-servicing problems. The Committee also expressed concern that the Baker Plan could indirectly put US taxpayers on the hook for additional bad loans, should the banks eventually have to be bailed out—a concern expressed in many Shadow statements throughout the years.

In November 1987, the Committee laid out a more comprehensive four-part plan for resolving the LDC crisis: (1) debtors and creditors should reschedule debt obligations without the active involvement of the US government or international agencies; (2) debtor countries should adopt policies encouraging the repatriation of their nationals' capital held abroad; (3) debtor countries should improve the efficiency of their own economies by privatizing state-owned enterprises; and (4) to encourage repatriation and privatization, debtor nations should encourage swaps of dollar-denominated debt for equity in local companies, analogous to private-sector restructurings of private companies. However, the LDC debt crisis continued to linger, and in September 1989, the Committee opposed congressional efforts to enable banks to reduce their reserves against losses on these loans if they also extended new credit—a legislated "forbearance" that the Committee argued was inappropriate (46).

In December 1989, the Shadow Committee again urged banks and debtor countries to reschedule the debt on their own without government involvement, which the Committee argued would only delay needed adjustments by all parties, such as the banks recognizing losses and the countries selling state-owned companies and improving the efficiency of their economies. Accordingly, the Committee opposed US government-led efforts at debt renegotiation, this time under the rubric of the Brady Plan, devised by Baker's successor, Treasury Secretary Nicholas Brady under the George H. W. Bush administration. The Brady Plan encouraged the World Bank and the International Monetary Fund (IMF), institutions both backed in part by US taxpayers, to extend new credit to LDC debtor countries (49). Ultimately, much of the LDC debt was rescheduled but with official guarantees, some debtor countries privatized some of their state-owned companies, and there were some efficiency improvements in these countries—meeting at least some of the objectives the Committee had outlined in 1987.

SEIR was motivated not only by the highly publicized troubles of the nation's largest banks but also by the mounting numbers during the 1980s of high-cost failures of smaller banks.

Having a market-centric view of the world, particularly bank regulation, does not rule out targeted assistance to troubled banks, provided the assistance can reasonably turn banks around while the Federal Deposit Insurance Corporation (FDIC), the typical provider of aid, receives equity in return. The Committee expressed that view in 1986 with respect to agricultural banks (2), and it later became relevant during the 2008 financial crisis (discussed later in this book).

In addition, the Committee urged the FDIC, the government agency that assumes equity in return for open bank assistance, to sell that equity stake as soon as practicable, which in the case of the government's nationalization of Continental Illinois, the Committee argued the FDIC did not do (64). Still, despite supporting aid-for-equity in some circumstances, the Committee remained generally skeptical of forbearance from enforcing capital standards for banks, as it was for thrifts (7, 14).

The Shadow Committee first weighed in on the development of risk-based bank capital standards in June 1986, endorsing the importance regulators appeared to be giving to including off-balance-sheet commitments in any capital calculations (6). Otherwise, the Committee was highly critical of the standards themselves, on multiple grounds: the risk weights were arbitrary, they did not take account of interest-rate risk (the mismatching of maturities of bank assets and liabilities) or diversification of assets, and the asset measures were based on historical costs of assets rather than their market values. Over the next three decades, the Committee was consistent in voicing these concerns or objections to the risk-weighted capital standards, even as they were refined by the Basel Committee in later years (18, 19, 29, 68, 154, 156, 169, 193, 267, 323).

The Committee objected to or expressed concerns about other aspects of the Basel capital requirements as well. In 1998, for example, the Committee objected to a proposal by US bank regulators, which has since been imitated by regulators in other Basel countries: using private credit ratings on securitized loans to determine their risk weights in setting capital standards (149). The Committee focused on a now-familiar problem in the ratings business, that issuers pay ratings organizations and thus create a potential for a "race to the bottom"—a potential that became a reality during the subprime mortgage crisis the following decade.

The Committee also objected to micromanagement of capital inherent in using ratings to assign risk weights, a sentiment expressed in September 2007, when what would later become a full-fledged financial crisis was beginning to unfold (248, 249). And, the Committee argued, the 50 percent risk weight given to mortgages or securities backed by them, coupled with Basel II's permission for some banks to use their internal models to set required capital ratios, aggravated rather than dampened the forces that ultimately led to the 2008 financial crisis (248, 253).

Actually, the Committee's objections to capital micromanagement dated much earlier, reflected in a statement issued in September 1989, when the Committee endorsed supplementing the risk-based standards with a minimum leverage ratio, an idea proposed by the comptroller of the currency for national banks (44). The Committee nonetheless objected that the proposed 3 percent of asset leverage standard was too low, a position it took again three months later after the Federal Reserve proposed the same supplemental leverage ratio (50).

In December 2005, the Committee expressed concern that capital calculated according to risk-weighted measures put many banks below the leverage ratio, and therefore it urged that the leverage ratio be retained as backup and indeed as a potentially binding constraint on bank leverage (223). Even when regulators did adopt a backup leverage ratio after the financial crisis of 2008, it was set at a level, again 3 percent of assets, that the Committee consistently had argued was much too low (335).

The risk weights in the Basel standards, meanwhile, have remained in place since they were first introduced, although they have been refined. The arbitrariness has continued, and the standards have never incorporated measures of interest-rate risk or asset diversification, despite Committee urgings to do so (82, 110).

Eventually, the Shadow Committee suggested that the Basel Committee focus instead on being a clearinghouse of best regulatory practices (its initial historical role in the 1970s and early 1980s), while permitting national regulators the freedom to design their own rules for banks operating within their borders (321). This suggestion implies a vastly scaled-back role for the Basel Committee, an outcome it almost certainly would not accept, but the only one that the Shadow Committee members have long believed is most appropriate.

Throughout its life, the Shadow Committee also criticized the Basel standards and national bank standards for calculating the required capital ratio based on the book value or historical costs of their assets rather than their market value. My personal view differs; market values are useful, if not preferable, only in "good times" and for assets with a ready market. Much of a bank's portfolio, however, consists of customized loans that are not traded and for which no liquid market exists. This has long been the essence of banking, after all: taking customers' deposits and using them to fund individual consumer and business loans that are not likely to be readily tradable—although in recent times, capable of being used as collateral for loan-backed securities.

Moreover, in times of severe market stress, even market values for marketable securities, such as the mortgage-backed securities at the heart of the 2008 financial crisis, can be temporarily deflated by panic-driven selling that does not reflect their long-run value. In such situations, forcing banks or financial institutions that otherwise have strong long-run earnings potential to mark-to-market accounting can drive them into insolvency that may not be justified. And from a system-wide perspective, mass insolvencies driven by mark-to-market accounting can turn a financial downturn into a crisis.

This is why, in the 1980s, many or all of the bank regulators engaged in regulatory forbearance of the nation's largest banks, some or all of which could have been rendered insolvent had their loans to LDC sovereign and private-sector borrowers then been marked-to-market. Eventually, these banks earned more than enough in the rest of the decade to offset the losses they would eventually be forced to recognize on their loans to LDC borrowers. Moreover, another reason for regulators' restraint in the 1980s was that the bank deposit insurance fund, the FDIC, like the Federal Savings and Loan Insurance Corporation with insolvent thrifts, had nowhere near the resources in the 1980s to resolve all or nearly all of the largest banks or to inject capital into them, as Congress authorized the Treasury to do during the financial crisis of 2008.

To be sure, it can be argued that, had banks before the LDC debt crisis (or later, before the 2008 financial crisis) been required to mark all their assets and liabilities to market, the banks would have been far more careful in their lending than they were. In that sense, it makes a big difference when a market-value-based capital regime is implemented. If introduced and adhered to during a quiescent period, then it can usefully deter banks from excessive risk-taking, but if introduced during a crisis, market-value accounting regimes can be highly counterproductive.

The arbitrariness has continued, and the standards have never incorporated measures of interest-rate risk or asset diversification, despite Committee urgings to do so.

In any event, it would have been more unthinkable in the 1980s than it was in 2008 for the federal government to have partially nationalized all its major banks, holding them until they returned to health. Nonetheless, in November 1986 the Shadow Committee endorsed the idea of "open assistance" from the depository insurance funds in return for equity of banks and thrifts that had a reasonable chance of recovering (27). Still, the Committee cautioned in its statement in February 1988 that the FDIC hold any such equity interests on only a temporary basis to avoid nationalizing banks and thus distorting banking markets. In early 1992 and later, the Committee's position on this subject evolved further, as it worried that the policy of temporarily "hospitalizing" ailing banks until they returned to health was not the least-cost way of resolving their problems, as required by law (80, 85).

Of course, as readers know well, less than two decades later this is precisely what federal regulators did on a much larger scale during the financial crisis of 2008. Bank regulators in October 2008 compelled the nation's nine largest banks to accept injections of capital from the Treasury, financed by the Troubled Asset Relief Program (TARP), to instill confidence in the banking system as a whole and to prevent runs on what were perceived to be the weakest banks. TARP funds were also injected into many other smaller banks that were short of capital.

The reserves held by the FDIC can never be adequate during a truly systemic event.

This reaction to the crisis underscores that the reserves held by the FDIC can never be adequate during a truly systemic event. Only a much more massive show of financial force, whether appropriated from Congress or mobilized by the Federal Reserve, or both, can prevent a financial system teetering on the edge from collapsing.

This lesson also underscores the limitations of capital held by individual banks or their holding companies from holding back a true run on the financial system as a whole. Nonetheless, the Federal Reserve has seemingly acted as if this were possible through its "source of strength" doctrine, by which bank holding companies have been obliged to inject capital into any troubled or failing bank subsidiaries.

Early in its life, the Shadow Committee opposed this policy (17). It argued that an effective bank closure rule that closed or forced the recapitalization by *other* shareholders of troubled banks was superior to a vague and arbitrary policy that discriminated against one type of bank shareholder, namely the bank holding company, and for which the legal authority was not clear. Nevertheless, in November 1987 (24), the Committee urged the Fed to overrule a previous policy that had barred bank holding companies from acquiring healthy thrifts—a policy that would look anachronistic today, given the demise of meaningful distinctions between thrifts and commercial banks, coupled with nationwide banking.

Interim Epilogue

The banking crises of the 1980s and early 1990s led to some unusual policy responses, which both did and did not presage later responses to the more serious crisis of 2008. The policy of regulatory forbearance for the nation's largest banks, which banking regulators engaged in out of necessity, as they saw it, turned out all right—some would say by accident, others by design. Two decades later, however, forbearance, among other policy mistakes we will review later, helped lead to the 2008 episode.

Perhaps because they wanted to protect the deposit insurance fund before tapping taxpayers, or perhaps for other reasons, regulators also applied the "source of strength" doctrine, by which bank holding companies are compelled to rescue, as best they can, their banking subsidiaries. Regulators have adhered to that doctrine, although it did not prevent an unprecedented $700 billion, congressionally authorized financial rescue effort.

The banking crises of these two decades also led to the adoption of more formal, although novel and later criticized, risk-based capital ratios, as well as to the implementation of SEIR. As Shadow members could be justified in saying, "you win some, you lose some." Readers will see proof of that saying in the next two chapters.

Notes

1. One senior legislative aide on the staff of the Senate Banking Committee at the time, Richard Carnell, who currently teaches law at Fordham Law School, deserves credit for persuading senators to include SEIR into the law.

V. Deposit Insurance and Safety-Net Reform

Federal deposit insurance is one of the best-known and most durable banking reforms launched during the Depression. Its presence has helped stabilize the financial system during subsequent crises, and as I discuss later, the concept of insuring not only deposits but also other bank and nonbank liabilities was stretched greatly during the latest crisis in 2008.

The agency that administers deposit insurance, assesses bank premiums, holds the fund, and closes and pays for failed banks, if necessary, is the Federal Deposit Insurance Corporation (FDIC). As readers already have learned, the FDIC fund's size can and does affect regulatory policy. Other things being equal, when regulators believe the fund's size is ample to cover the cost of likely future bank failures, they are more likely to avoid forbearance—or waiting and hoping until things get better so they will not have to tap the fund or tap it to the degree they otherwise might. If the fund faces a shortfall, forbearance is much more tempting, if not likely—as we saw during the thrift and banking crises of the 1980s.

As early as December 1988, the Shadow Committee warned that not only was the insurance fund backing thrift deposits massively undercapitalized, but also the bank deposit insurance fund maintained by the FDIC was essentially exhausted (36). This was well before the failure in 1991 of the Bank of New England, then one of the largest regional banks in the country.

Later that same year, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which authorized the FDIC to borrow up to $30 billion from the Treasury to cover any temporary losses, while directing the insurer to collect sufficient assessments on deposits from US insured banks to restore the insurance fund to financial health. This eventually happened—for more than a decade—until the big financial crisis of 2008.

Shadow Statements

Even before the enactment of the FDICIA, the Committee was weighing in on how the FDIC's insurance program should be managed. In December 1988, the Committee urged the FDIC to assess premiums on US bank deposits held in their foreign offices and on their unsubordinated liabilities (37). This suggestion applied to only the nation's largest banks with foreign offices and was meant to shore up the insurance fund while recognizing that regulators were unlikely to require these creditors to take losses in the event the banks failed. Under these circumstances, why not at least collect premiums on these liabilities? The FDIC later answered this question in the affirmative and adopted this policy.

In September 1990, the Committee again warned of the FDIC's precarious financial condition and supported the legislation that was ultimately adopted to increase the FDIC's borrowing authority (59). In the same statement, the Committee argued that raising deposit insurance premiums by itself was not sufficient to discourage risky bank behavior in the future and accordingly urged that a regime similar to structured early intervention and resolution (SEIR) be adopted to strengthen the banking system.

At the end of 1991, the Committee repeated its call for prompt congressional action to recapitalize the FDIC insurance fund, which by that time was widely recognized to be insolvent, through upfront taxpayer financing, repaid by a one-time assessment on healthy banks (66). The Committee also proposed that any legislation providing necessary funding to the FDIC constrain the Federal Reserve from lending to insolvent institutions and that the legislation not be weighed down by extraneous and potentially counterproductive measures, such as the reimposition of ceilings on deposit interest rates (70, 73). Later the Committee urged that Treasury—and hence taxpayer—funds be committed to shoring up the FDIC's insurance fund, which was too depleted to be financed solely by higher bank insurance premiums, even if they were risk-related, which the Committee endorsed in principle. But the Committee criticized the FDIC's 1992 proposal in practice for charging "safe" banks too much and riskier banks too little (83).

If SEIR were working properly, then early intervention by bank regulators to force undercapitalized banks to restrict dividends or raise additional capital would be sufficient to ensure bank safety without micromanaging individual banks' operations.

The FDICIA eventually was enacted at the end of 1991, with an SEIR enforcement regime. The law directed that capital standards take account of off-balance assets and liabilities and that banks report their conditions based on market values of assets and liabilities, although the act did not require the capital ratios actually *be based on* market values. The Shadow Committee broadly endorsed these FDICIA provisions (76).

The FDICIA also reduced the "too big to fail" (TBTF) problem by prohibiting the Fed from lending to "critically undercapitalized" banks, while directing the FDIC not to pay uninsured depositors in arranging a takeover of a failed institution, unless the total cost of doing so would be less than the cost of liquidating it. The Committee applauded these provisions, too, as major steps forward but stressed that effective implementation of the law remained key (76)—a recommendation that was not strictly followed about 15 years later in the run-up to the financial crisis of 2008.

At the same time, the Committee expressed skepticism about the need for a raft of additional detailed regulatory standards. If SEIR were working properly, then early intervention by bank regulators to force undercapitalized banks to restrict dividends or raise additional capital would be sufficient, in the Committee's view, to ensure bank safety without micromanaging individual banks' operations (89). In February 2007, the Committee endorsed one narrow exception to this principle: an FDIC proposal requiring banks, particularly large ones, to keep up-to-date information about the insurance status of their accounts so that they could easily be paid off in the event of failure. In the absence of such information, regulators could be more tempted to protect all deposits, even those uninsured, and thus aggravate the TBTF problem (239).[1]

One factor that may have delayed addressing the FDIC's financial shortcomings in the late 1980s and early 1990s was that the deposit insurer reported its financial condition only on a cash basis, deducting from its reserves only when it had to make payments out of its fund. In September 1991, the Committee applauded an initiative by the Office of Management and Budget—a similar one had been suggested by the Congressional Budget Office—to require the FDIC to report on an accrual basis (72). Under this approach, the FDIC would also deduct from its reported reserves a probabilistic estimate of future losses from bank failures, an approach that the FDIC has since tried to follow.

Eventually, the FDIC's bank insurance fund—which was ultimately merged with the fund backing deposits at savings institutions—recovered, on the strength of the banking industry's bounce back from its FDICIA-era lows, when banks holding 25 percent of all bank assets were classified as being undercapitalized. By late 1995, when the bank insurance fund had reached its statutory minimum reserve ratio of 1.25 percent of banking system assets, the Committee was recommending that bank regulators raise their minimum capital ratio "tripwires" by 1 percentage point (126). The Committee argued that this was especially necessary because, by that time, healthy banks were paying no premiums at all for deposit insurance. The Committee opposed this policy decision on the grounds that insurance premiums are meant to cover forward-looking risks, and so all banks should at least continue to pay some premium according to the risks they posed to the insurance fund (127).

The Committee opposed, on multiple occasions, efforts to raise the deposit insurance ceiling (165, 175). For example, in May 2005, the Shadow Committee recommended against pending legislation that would have raised the insurance ceiling to $130,000, while delaying scheduled increases in deposit insurance premiums to meet a statutory minimum reserve-to-deposit ratio (220).

After Congress enacted the Deficit Reduction Act of 2005, it enshrined the delay in raising insurance premiums, a step the Shadow Committee criticized as shortsighted (226). The Committee followed up with a critique of a complicated, ostensibly risk-based system for assessing insurance premiums proposed by the FDIC in 2006, which the Committee faulted for, among other things, not taking account of the magnitude of potential losses given failure and for excluding situations in which fraud accounted for prior bank failures (233).

The deposit insurance ceiling nonetheless was raised significantly to $250,000 during the 2008 financial crisis. The law creating the $700 billion Troubled Asset Relief Program (TARP) for supporting (many would say bailing out) the nation's weak banks included the higher insurance ceiling for two purposes: to immediately stop or prevent any deposit runs on the largest banks, which have more large-dollar accounts than their smaller counterparts, and to help address the relative disadvantage that smaller banks faced in competing against TBTF banks for larger deposits.

In early 2010, the FDIC proposed a new risk-based system for assessing deposit insurance premiums for large banks. This system was to be based on bank CAMEL ratings and the FDIC's statistical risk modeling. While the Committee generally applauded the FDIC's initiative, it also urged the agency to separate modeling of future default probabilities from future expected losses. More broadly, it urged the FDIC to impanel a group of independent experts to validate or suggest improvements in any new risk-based premium structure (291).

One part of the FDICIA has since become highly controversial: the systemic risk exception, which permits the FDIC to protect all otherwise uninsured deposits in the event of a systemic crisis. In the popular vernacular, this is the TBTF part of the law, although sometimes TBTF critics overlook that the protection afforded to uninsured depositors (or creditors) by the systemic risk exception does not extend to shareholders under the act.

Eventually this seemingly narrow exception would play a crucial role in the federal government's reaction to the 2008 financial crisis. The FDIC invoked the exception several times in connection with individual large-bank rescues and in a more general extension of insurance protection to both large uninsured bank deposits and new senior bank debt. In a related move, the Treasury Department used its Exchange Stabilization Fund—which had been tapped earlier by Secretary of the Treasury Robert Rubin to assist Mexico during its debt crisis in the 1990s—to protect money market mutual fund accounts against future runs. Both of these actions, as well as the broader financial rescue efforts mounted by the Federal Reserve and the Treasury, funded by TARP, have since become hot-button political issues.

The Committee never was enthusiastic about the systemic risk provision, worrying that its open-ended character subjected it to abuse. In fact, in May 2000, the Committee opposed raising the deposit insurance ceiling to $200,000, which smaller banks had been pushing to reduce the inequity with TBTF banks, and urged that it be rectified by narrowing the systemic risk exception instead (162).

The Committee never was enthusiastic about the systemic risk provision, worrying that its open-ended character subjected it to abuse.

Had this latter proposal been adopted, the FDIC and other bank regulators would have had more difficulty dealing with the financial crisis eight years later, although perhaps any narrowing of the exception may have discouraged the largest banks from taking excessive risks in the first place, which exposed them and the financial system to such great risks when the subprime mortgage crisis hit. We will never know which view is right—although readers hopefully will continue reading until Chapter 15, where I outline a counterfactual narrative of financial and economic events if some of the other core Shadow Committee recommendations had been in place throughout.

The FDICIA also required the FDIC to consider implementing, on a pilot basis, a program to privately reinsure some (small) portion of its risk. In early 1993, the FDIC announced such a program to cover up to 10 percent of the insurance fund's risk.

While endorsing the idea in principle, the Committee urged the FDIC to realize that the pilot would not be useful unless it gave private reinsurers access to the same kind of information that any insurer would want to set actuarially sound premiums (97). In this context, such information would include bank examination reports, whose public release the Committee has long advocated (132), and reports of banks' financial conditions based on their market values.[2]

Congress adopted another little-noticed deposit-insurance-related reform as part of the Omnibus Budget Reconciliation Act of 1993. The reform, meant to raise some revenue for the FDIC over the (then) five-year budget scoring window, gave claims of depositors at domestic branches of FDIC-insured banks and thus gave the FDIC, in the event of a bank failure, preference over other claims in distributions from all future FDIC receiverships.

The Committee noted that one unintended consequence of this legislation would be to encourage foreign depositors and general creditors to take various measures to assure greater security of their investments—such as requiring collateral or shortening the maturity of their deposits—which could cancel out any risk-reducing impact of the depositor preference law. The FDIC, in turn, could take countermeasures, such as redesigning its deposit insurance premiums. The Committee stated that seemingly innocuous legislation added as an appendage to a much larger bill can have multiple unintended long-term consequences that may not be fully considered when Congress acts in haste to achieve some short-term objective—in this case, just $1 billion of budget savings (98).

The Future of Deposit Insurance

Given the various financial crises of the past three decades, the future of some form of bank deposit insurance is secure. The only major remaining question is whether, at some point, Congress formally recognizes the de facto reality of protecting deposits at the largest, systemically important banks and extends deposit insurance to all deposits at all banks, or if Congress moves in the other direction and either cuts the deposit insurance ceiling or revokes the systemic risk exception now written into the FDICIA in an effort to end TBTF.

My guess is that the former approach is more likely. If this happens, then regulators will be under even greater pressure to prevent banks from taking excessive risks in the future, something they failed to do in the run-up to the 2008 financial crisis, which is the subject of the next chapter.

Notes

1. In December 2007 the Committee issued a related statement that reinforced this suggestion (254).
2. In doing research for this book, I could not find out whether private reinsurers ever took the FDIC up on the idea and what the FDIC did, if anything, with the information from running the program.

VI. Banking Regulation in the 1990s and 2000s—Until the Financial Crisis

Even before the structured early intervention and resolution (SEIR) regime of banking regulation—embodied in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and urged long before that by the Shadow Committee—was enacted into law, policymakers began debating the future role of banking supervision after the mini banking crisis of the late 1980s and early 1990s had passed. (I am able to call that crisis a mini one only because I and readers know that a much, much larger crisis occurred about 15 years later.)

The initial discussion got off on the wrong foot, at least in the minds of Shadow members. That was in 1991, when charges were widespread that crackdowns by bank regulators on banks' lending after the crisis were creating a "credit crunch." Similar charges were made following the financial crisis of 2008.

It is a natural reaction after any crisis, or at least any major upturn in depository institution failures, for regulators to take a tougher look at the institutions they supervise, not only because they may believe that some laxity on their part could have prevented or at least minimized the increase in bank failures but also because they want to avoid future congressional and media criticism for again appearing to fall asleep at the switch. But regulators often find themselves in a no-win position. Once they toughen up, they are then frequently criticized for overcorrecting, sometimes by the same political leaders and observers who had just attacked them for being too lax. Excessively tight supervision inhibits bankers from lending and thus prevents the broader economy from recovering from any downturn that may have triggered or accompanied the rise in bank failures.

Finding the right balance—between being too lax and too stringent—is the greatest challenge that safety and soundness regulators always face, and they probably will never get it perfectly right. This challenge is endemic in solvency regulation of any type of financial institution, and it was the subject of numerous Shadow statements during the 1990s and early 2000s, which turned out to be a period of relative calm (before the 2008 storm) for depository institutions.

Shadow Statements

Political criticism of bank regulators for causing a "credit crunch" was the topic of a Shadow Statement in February 1991 (67). The Committee raised questions about the empirical basis for the claim and instead urged elected officials to let regulators do their jobs. An earlier statement made the same suggestion (62). Along the same lines, in December 1991, the Committee criticized the four banking agencies themselves for appearing to relax supervisory standards for bank commercial real estate lending as a way of providing macroeconomic stimulus to the economy, an inappropriate thing for bank supervisors to do, in the Committee's view (79).

In 1993, the Committee again voiced concerns about using bank examination—actually, a laxity in examination—as a tool of macroeconomic stimulus by exempting banks with CAMEL ratings (the abbreviation of the long-used formula for assessing bank safety) in the top-two categories from detailed documentation requirements for their business and agricultural loans (94). Ironically, this practice of permitting "low doc" loans was far more widely used in the following decade for mortgages and was a contributing factor to the subprime mortgage crisis. The Committee also criticized the infrequency of bank examinations at the time, which led to CAMEL ratings often being out-of-date and thus more of a lagging than a leading indicator of potential bank problems (94).

Another highly publicized (at the time) failure by bank regulators was highlighted by the collapse of the Bank of Credit and Commerce International (BCCI) in 1991. BCCI was headquartered and supervised outside the United States, although it did business in this country. It fell because of massive fraud.

The obvious question, which the Committee raised in September 1991, was why regulators took so long to catch on (74). The Committee was especially concerned about regulators' failure to effectively watch the parent company and about the ability of sophisticated creditors of the bank to get out before many other less sophisticated depositors, whose accounts were not insured.[1] Going forward, the Committee urged that foreign banks be permitted to operate only through separately capitalized subsidiaries that can be effectively supervised and monitored by US regulatory authorities, an idea that regulators later adopted after the 2008 financial crisis.

Although few bank failures occurred in the 2000s until the 2008 financial crisis, risks were rising in the banking system. As I discuss elsewhere in this book, regulators missed the huge risks posed to the largest banks by securities backed by subprime mortgages held in the banks' ostensibly off-balance-sheet structured investment vehicles (SIVs). But even before these risks and their attendant losses became apparent in 2007, the Shadow Committee applauded the federal banking regulators for warning about the growing concentration of risk in commercial real estate lending, which contributed to rashes of bank failures in the past (235).

At various points in the Shadow Committee's 30-year history, proposals were offered by academics and congressional representatives to streamline, consolidate, or otherwise reform the highly fragmented nature of US bank regulation—which, due to a series of historical accidents, has been split among multiple regulators: the Office of the Comptroller of the Currency (OCC) for national banks; the Federal Reserve for bank and financial holding companies and for state-chartered banks belonging to the Federal Reserve; the Federal Deposit Insurance Corporation for state-chartered banks not belonging to the Federal Reserve; and until the enactment of the Dodd-Frank Act of 2010, a separate thrift regulator, once the Federal Home Loan Bank Board and later the Office of Thrift Supervision (OTS). None of the various reform proposals have ever been adopted, largely because of strong opposition of the regulatory agencies themselves (all fearing to give up turf) and because of differing views within the banking community about which regulatory structure would work best.

Although few bank failures occurred in the 2000s until the 2008 financial crisis, risks were rising in the banking system.

Nonetheless, the Committee did comment on a few of these restructuring proposals. For example, in late 1993, the Clinton administration proposed consolidating all the bank regulatory agencies into a single Federal Banking Commission, leaving the Fed with authority over only monetary policy and the payments system. The Committee endorsed this idea, provided that the FDIC chair belonged to the commission and that the Treasury secretary did not, to preserve the commission's independence (100).

In early 1994, the Committee formalized its suggestions for restructuring the financial regulatory agencies by setting forth a series of principles for doing so, but without endorsing any particular reform idea (103). In December 1998, the Committee argued against having the Federal Reserve retain any role in regulating banks or their holding companies, pointing to conflicts between the Fed's regulatory functions and its control of monetary policy (153).

In the early stages of the financial crisis in May 2008, the Committee again voiced its opposition to the Fed's supervisory role, but in a different context: that its involvement in supervising not only bank safety and soundness but also consumer protection invited political pressure for the Fed to intervene in other ways (260). With the benefit of hindsight, this critique did not anticipate a different sort of political pressure—specifically, a political backlash—that hit the Fed with full force after its multifaceted rescue operations and monetary expansions after the crisis. I personally was and remain sympathetic with the Fed's efforts in these regards, especially given the tightness of fiscal policy after the 2009–10 stimulus, and I believe that history will treat the central bank and its leaders more kindly than has been the case in recent years.

The Shadow Committee's recommendations that the Fed not be involved in bank supervision, of course, have not been followed. Indeed, the Committee implicitly accepted this outcome and in 2000, the year after the Gramm-Leach-Bliley Act was passed, urged each of the three bank regulatory agencies to charge examination fees to the banks to cover the cost of supervision (161). Historically, only the OCC has charged the national banks for this purpose, and to this author's knowledge, the other two bank regulators (the Fed and the FDIC) have never been required to do so.

Later, during the debate over the Dodd-Frank Act, various ideas were introduced for restructuring bank regulatory agencies, but ultimately only the OTS was eliminated, and its functions were consolidated with those of the OCC. The central bank's regulatory role was vigorously debated, but ultimately the Fed retained its supervision of banks, their holding companies, and diversified financial holding companies, although it was forced to share authority in designating whether a financial entity was systemically important with other agencies belonging to the newly created Financial Stability Oversight Council.

Another controversial bank regulatory issue that the Committee addressed concerned the Community Reinvestment Act (CRA), which Congress enacted in 1978 to encourage banks to lend to individuals and firms in low- to moderate-income geographic areas. While the Committee supported the Equal Credit Opportunity Act, which prohibits discrimination in lending on the basis of race, gender, national origin, marital status, and age, it urged the repeal of the CRA, advice that policymakers have never followed.

In September 1994, the Committee first outlined its specific objections to the CRA: the act was based on the false premise that banks should deploy their deposits first to loans in their local areas rather than where they can be most profitably invested, and CRA's implementing regulations distorted credit markets, effectively compelling banks to allocate credit disproportionately to special-interest groups capable of extracting concessions from banks (105). Later that year, the Committee argued there was no credible evidence of a market failure in extension of credit in low-income communities, while criticizing then-proposed implementing regulations for their complexity (113). Instead, the Committee urged that inner-city problems—crime, joblessness, and inadequate economic development, among others—be addressed directly through on-budget government expenditures (105).

My own personal view about the CRA has been different. Given budget realities, I do not believe that even effective programs for reducing poverty wherever it exists, not just in inner cities, will be adequately funded by direct expenditures, or even generally less efficient tax expenditures. Moreover, I do believe there are market failures in providing credit to individuals and businesses in low-income areas. The problem is analogous to the underfunding of public goods.

There would be more creditworthy borrowers and businesses if many banks provided credit in low-income areas *simultaneously* to multiple projects.

The problem is that funding a single building, project, or business is highly risky; risk would be reduced if each bank and borrower knew that other banks and borrowers would be lending or receiving credit, so that the whole community would be better off. The CRA is designed to solve this chicken-and-egg problem in inner-city lending.

However, I do share the Committee's critique about the complexity of the regulations implementing the act. I have long preferred a simple percentage-of-loan safe harbor as a way for banks to comply with the CRA, but the idea has never taken root.

Meanwhile, the local and national debate over how to meaningfully address inner-city problems continues to this day, although some inner cities have come back, but generally not without pushing low-income families to inner suburbs.

There would be more creditworthy borrowers and businesses if many banks provided credit in low-income areas *simultaneously* to multiple projects.

Interim Epilogue

The debate over the conduct of banking supervision has intensified greatly in the aftermath of the 2008 financial crisis. By their own admission, financial regulators failed to adequately supervise some of the nation's largest banks in the run-up to the crisis, permitting them to take on too much mortgage risk directly, to do so indirectly through the creation of theoretically off-balance-sheet SIVs, and to engage in other abuses for which they have paid or are likely to pay heavy fines and damages in civil lawsuits.

Nonetheless, policymakers since the crisis have doubled down on bank regulations to prevent future crises. The tougher approach to bank supervision, including the new stress tests for the largest banks, is little different in character to the counter-reaction that bank regulators exhibited after the savings and loan and banking crises of the 1980s and early 1990s. Indeed, it is only natural for regulators to close the barn door after the horses have escaped, if only to protect themselves against charges of being too lax in the event of a future crisis. Whatever view one takes of the latest regulatory counter-reaction, it is important that it not be confused, as it tends to be in the political arena and media, with the controversial Dodd-Frank Act, which contained many new regulatory provisions aimed at preventing future financial crises.

The Shadow Committee spoke many times during its life about the importance of bank supervision and examination, but primarily as an instrument to enforce SEIR, which requires accurate, and ideally market-based, measurement of a bank's financial health at all times. For more than a decade after the FDICIA was enacted, regulators seem to have implemented SEIR, but then they abandoned it in the years preceding the 2008 financial crisis. Since that time, as will be discussed later, bank capital standards have been lifted, giving banks and regulators a larger margin of safety. Whether regulators will continue to adhere to SEIR in the face of future financial ups and downs remains to be seen.

Notes

1. This position was admittedly at odds with a later Shadow statement, 118, voicing objections to bank holding company supervision in general.

VII. Enhanced Competition in Financial Services

Financial-service firms and markets have been heavily regulated, especially since the Great Depression. Assuring the safety and soundness of financial intermediaries through close monitoring and regulation of their capital strength—measured in relation to assets (banks) or revenues (insurance)—has been especially obvious and necessary, even though regulators have proved occasionally, and in the run-up to the financial crisis of 2008 in a big way, that they are far from perfect.

Capital regulation of financial intermediaries is important primarily because of the nature of the liability side of the institution's balance sheets: deposits for banks, insurance policies for insurers, and investment accounts for brokerages. In each case, the institution accepts funds from customers and promises to pay them back, either if they want the funds back or, in the case of insurance, if a loss event covered by the contract entitles the policyholders to a payment of their (legitimate) claims. None of these contractual arrangements would exist unless the customers who provide financial institutions with funds trust them to have the requisite assets to honor these promises. Regulating the institutions' financial soundness thus serves the broader interests of the economy and society in preserving that trust.

Introducing guarantees (up to some limit) of these accounts or claims—deposit insurance for banks in 1933 and state guaranty funds for insurance policies since the early 1970s—reinforces the case for safety and soundness regulation. While such guarantees enhance trust in specific institutions and the financial system more generally, they also reduce incentives by those protected to monitor specific institutions' financial health. This moral-hazard effect may not be significant for the vast majority of retail account holders who lack the time or knowledge to be effective monitors, but the absence of the market discipline exercised by larger account holders or policyholders can permit these institutions' managers to take greater, unwarranted risks that they otherwise might avoid.

Effective government safety and soundness regulation, at least in principle, can offset this tendency. Much of the Shadow Committee's time and energy during its 30-year span was devoted to improving the effectiveness of safety and soundness regulation for all financial intermediaries, particularly depository institutions.

Financial institutions and markets have also been regulated in many other ways, independent of their financial strength. Economists and the SFRC have been more skeptical of this broader regulatory agenda, either because a market failure did not require government to intervene or because such regulation can and has inhibited socially valuable competition among financial institutions.

Three types of unnecessary regulation, each dating from the Depression or before, have been phased out over the past several decades, consistent with the foregoing critiques. These three types are:

- Ceilings on interest rates that depository institutions could pay their depositors (Regulation Q), which Congress eliminated in the Depository Institution and Monetary Control Act of 1980, and later in the 2000s, the removal of the prohibitions on payment of interest by banks on commercial checking accounts and by the Fed on bank reserves;

- The federal prohibition on the branching of banks or expansion of bank holding companies across state lines, phased out over several years by Congress in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994; and

- Activity restraints on banks and their holding companies under the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956, relaxed to some degree by the Federal Reserve Board in the late 1980s and largely eliminated in the Gramm-Leach-Bliley (GLB) Act of 1989.

Interest-rate deregulation has proved to be uncontroversial and indeed is now widely accepted as having saved the depository system from a massive outflow of deposits in the early 1980s, when interest rates on money market funds, which are purchasers of short-term Treasury bonds, soared well into double digits, far above the Regulation Q ceilings of roughly 5 percent for banks and thrifts (as discussed in Chapter 2). Congress' decision in the 2000s allowing the Fed to pay interest on bank reserves, a move supported by the Committee in 2003 (194), proved prescient when the Fed began in December 2015 to lift interest rates above zero, principally by paying interest on these reserves. The Fed turned to this tool because a surplus of bank reserves held with the Fed made it difficult for the central bank to directly control the "Fed funds" interest rate charged by banks for lending to each other.

Removing interstate banking restrictions has permitted the emergence of large national and regional banks. Most economists have viewed this development positively because it has enabled banks to diversify their deposits and loans more broadly than before. In the process, nationwide banking has helped improve the allocation of capital across the country.

Despite the limit written into the Riegle-Neal Act that no bank could acquire another if the acquisition would enable the resulting institution to hold more than 10 percent of the nation's bank deposits, that act has also allowed banks to grow organically, even if their share of nationwide deposits exceeded 10 percent. The growth of the nation's largest banks since the financial crisis of 2008, in particular, has aggravated the so-called "too big to fail" (TBTF) problem: the full protection of *creditors* of these institutions, which undermines market discipline against excessively risky behavior. Yet the creditor bailouts had the immediate benefit of insulating the economy against further economic damage from contagious deposit runs on not only multiple large banks but also potentially many smaller ones.

Nonetheless, critics of nationwide banking remain, pointing to the growing concentration of banking assets and the growth of TBTF banks in particular, which Riegle-Neal has facilitated. The Committee was aware of this downside of the act but maintained it was more than offset by its diversification and efficiency benefits.

The Committee was and has been opposed to reducing the TBTF problem through such arbitrary proposals as simply breaking up the largest banks. It has put forward several alternative ideas, discussed in later chapters, for reining in TBTF without sacrificing the efficiency benefits of nationwide banking and branching.

Congress enacted the GLB Act to remove barriers to increased competition in the securities underwriting business by permitting entry in that business of banking organizations and to allow diversified financial firms to realize "economies of scope." However, the GLB Act has proved to be the most controversial of the financial deregulatory measures. In part, that is because the benefits of activity diversification promised by GLB Act proponents, including the Shadow Committee and many of its individual members (including me), have not proved to be as great as envisioned. Indeed, the financial institution most associated with the passage of the GLB Act in 1999, Citigroup, which needed the act to remove legal uncertainties about its then-proposed acquisition of Travelers Insurance, later divested that company, apparently finding the synergies from banking and insurance underwriting to be elusive.[1]

Citi's action does not, however, necessarily disprove the long-run benefits of the "financial supermarket" model that the GLB Act was supposed to make possible. Notably, certain insurers, such as State Farm and USAA, have continued to offer banking services, and so for them, the diversification benefits appear to exist. More broadly, the combinations of commercial and investment banking that were already under way before the GLB Act—through the Fed's regulatory approvals but formalized by the act—also have continued, providing market-based evidence that these combinations, too, are having at least some synergistic effects.

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Nonetheless, there remains interest in restoring or updating Glass-Steagall. In fact, several presidential candidates during the 2016 primary campaign endorsed the reinstatement of the act, and the idea has attracted some interest in Congress. I address (and rebut) the new case for Glass-Steagall, and thus the repeal or significant modification of the GLB Act, at the end of this chapter.

Shadow Statements

The SFRC first addressed the activity constraints on banks and their holding companies in November 1986, when it endorsed four bank holding companies' applications to the Federal Reserve to engage through separate nonbank subsidiaries in underwriting various noncorporate securities (13). The statement reminded readers that such activities were permissible under Glass-Steagall as long as the subsidiary was not "principally engaged" in securities underwriting generally, and it pointed to the proposed restrictions on such underwriting in the banks' applications as easily consistent with that language.

In early 1987, the Fed approved these applications, decisions that were upheld after court challenge. In the meantime, Congress enacted in March 1987 a one-year moratorium on banking organizations further expanding their securities activities. Consistent with its support for more competition in financial services, the Committee urged in February 1988 that the moratorium be permitted to expire (25), which in fact it did. The Committee continued to press for wider securities activities by banking organizations, provided banks were subject to a structured early intervention and resolution (SEIR) capital regime (56, 115, 116), until the Gramm-Leach-Bliley Act of 1999 removed all limitations on both securities and insurance activities.

Likewise, beginning with a statement in September 1993, the Committee supported congressional efforts to expand competition in banking by lifting geographic restrictions on where banks could do business (99). The following year, Congress enacted the Riegle-Neal Interstate Banking and Branching Act of 1994, a move that the Committee strongly supported, beginning with its initial statement on the matter in December 1990 (63). The Committee stressed not only the competitive and efficiency benefits of nationwide branching but also the safety and soundness benefits to the banks themselves of having more diversified loan portfolios.

As the nation moved toward interstate banking either through branching or subsidiaries of common holding companies, which was formalized in the Riegle-Neal Act and endorsed by the Committee at the time (111), the Committee also urged federal policymakers to clear up inconsistencies between state laws on a variety of matters that can impede the efficient delivery of financial services. The solution: federalize laws relating to credit reporting, loan collateralization, and usury ceilings, among other subjects (107). This has happened to only a limited degree.

The Committee also urged for eliminating banking agency review of the competitive impact of bank mergers, arguing it was more efficient to leave that job to the Antitrust Division of the Department of Justice, which oversees (along with the Federal Trade Commission) the impacts of competition of mergers in other industries (128). This sensible suggestion—which in the author's opinion ought to be applied to other industries that have two layers of antitrust review, such as the airline industry—has never been adopted.

By 1995, the debate over liberalizing the powers of bank holding companies in the interest of promoting more competition throughout finance began heating up. The Shadow Committee supported such efforts, with the caveat that any new nonbanking activities found to be too difficult for bank examiners to monitor directly should be conducted out of separate nonbank subsidiaries of bank (or later, financial) holding companies (118). The Committee also opposed regulation of the holding companies themselves, given regulatory oversight of their bank subsidiaries (118). However, federal and state policymakers have never followed this approach, and indeed, with authority granted by the Dodd-Frank Act, the Fed has strengthened its oversight of financial holding companies, especially those deemed to be systemically important.

Likewise, in the mid-1990s, the Committee opposed early efforts, later embodied in the GLB Act, to prevent diversified financial companies owning banks from being affiliated with or owned by commercial enterprises (120, 138). The Committee found no evidence supporting the case for separating banking from commerce. The Committee's early support of including insurance activities as being legitimate for affiliates of banks, which the original financial liberalization legislation proposed by Representative Jim Leach would have prohibited, was later validated when the GLB Act was finally enacted four years later.

Until that happened, the Committee had urged regulators to make maximum use of their powers to expand the powers of banks and their holding companies in the interest of removing artificial barriers to competition in financial services (130, 136). In December 2005, the Committee supported Walmart's efforts to enter the banking business by purchasing an industrial loan company (ILC), a specialized bank chartered in Utah (224). But the Federal Deposit Insurance Corporation (FDIC) ultimately imposed a moratorium on commercial company acquisitions of ILCs, which the Committee also opposed, consistent with its opposition to separating banking and commerce (241). Later, in 2008, the Committee opposed legislation that endorsed the FDIC's position, but remarkably made an exception for auto companies' purchases of banks (256).

The Committee stressed not only the competitive and efficiency benefits of nationwide branching but also the safety and soundness benefits to the banks themselves of having more diversified loan portfolios.

As for the GLB Act itself, while the Committee generally endorsed the legislation, it proposed a far simpler alternative to the bill that was enacted: "The Bank Holding Company Act of 1956 and the Glass-Steagall Act of 1933 are hereby repealed" (155). Instead, the GLB Act, like much congressional legislation these days, ran several hundred pages long.

Two years after the GLB Act was enacted, the Committee issued a statement arguing that the act failed to achieve a principle objective: ensuring a viable two-way street whereby banking organizations could more easily enter nonbanking financial markets (securities underwriting and insurance activities in particular) and nonbanks could enter banking (174). At this two-year anniversary, the Committee noted that only the first part of this street, banking organizations venturing outside banking, was active. In contrast, on the other street, only one significantly sized securities firm or insurer had acquired a bank. The Committee attributed this imbalance to the GLB Act's requirement that the Federal Reserve regulate all diversified financial firms, a circumstance to which banking organizations had been accustomed, but which nonbanks were reluctant to accept.

In fact, several years earlier, while Congress was debating legislation that ultimately would become the GLB Act, the Committee had rejected the need for the Fed's consolidated supervision of diversified financial organizations owning banks, as long as SEIR was being followed. There would then be no need for holding company oversight or for the Fed to force banks to inject capital into ailing bank subsidiaries—that is, the "source of strength" doctrine (139).

This advice not only was not followed in the GLB Act but also was rejected again when Congress enacted Dodd-Frank. By the time Dodd-Frank was enacted, and indeed before, regulators had effectively abandoned SEIR, a mistake that aggravated the financial crisis that led to that act.

The Post-2008 Debate over Bank Activities Returns

In Chapter 13, I discuss the financial crisis of 2008 and its aftermath, especially the main features of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which continues to be controversial. In particular, the act continues to be attacked from both the left and right for not doing more to rein in or break up TBTF institutions and address the TBTF problem more generally. There also are bipartisan calls (but more so from Democrats) to reinstate some form of Glass-Steagall, which would force those few financial institutions that now have both commercial and investment banking operations to split them up into legally distinct entities.

The rationale for adopting a new Glass-Steagall (thus repealing the GLB Act) is forward-looking, rather than aiming to fix a preexisting problem, as it must be because there is no evidence that mixing commercial and investment banking—allowed fully by the GLB Act and partially in the Fed's deregulatory rulings in the decade preceding it—had anything to do with the 2008 financial crisis. Many banks that had no securities affiliates and mostly nonbanks originated the subprime mortgages that were assembled into mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) that later tumbled in value when delinquencies on those mortgages soared. In addition, these MBSs and CDOs were sold by investment banks that had no retail banking affiliates and by banks that had no securities affiliates.

Moreover, the legal ability that the GLB Act provided for combining commercial and investment banking operations into a single legal entity (but in separate subsidiaries) proved important in mitigating the 2008 crisis. Had the GLB Act not been in place, Bank of America would not have been able to save Merrill Lynch, nor would Goldman Sachs and Morgan Stanley have been allowed to seek bank holding status and thus Fed oversight, which they both sought in the worst week of the crisis to reassure their panicky repo lenders to roll over their loans.

Admittedly, the last crisis usefully highlighted the danger of runs in the repo market, which finances large securities underwriters. However, this risk exists whether or not an underwriter is affiliated with a bank, and it is one that I personally believe still has not been adequately addressed since the crisis. In particular, a case can be made that investment bank underwriters, or any businesses for that matter, should be prohibited from or at least sharply limited in their dependence on overnight money or even loans of short duration, even if those loans are collateralized, as they are in repos.[2]

Certainly the Fed, in the case of large investment houses operating with a bank or financial holding company structure, could find a way to directly or indirectly limit the share of the underwriters' funding that comes from overnight funds so that regulators (in particular, the FDIC under Title II of Dodd-Frank) in a future crisis are not tempted to protect their uninsured creditors or treat the entities as TBTF and thus hastily arrange their mergers with stronger acquirers. At this writing, the Fed appears poised to rein in short-term repo lending by requiring some amount of excess collateral for these borrowings.

Meanwhile, any claim that Glass-Steagall should be reinstated because of the fear that a failing underwriter can infect its affiliated bank, which in turn could trigger a federal rescue much like what happened with the large bank structured investment vehicles, ignores several important considerations. First, even under the GLB Act, no bank can legally absorb its securities affiliate or its assets and liabilities, which have to be maintained in a separate legal entity. Second, Sections 23A and 23B of the Federal Reserve Act tightly limit a bank's ability to lend to any nonbank affiliate. Third, unlike banks, securities underwriters seek to sell their assets—namely the securities in their portfolios—as quickly as possible, ideally even to pre-sell them as part of the underwriting process, which makes the asset side of the balance sheet of a securities underwriter inherently more liquid and safer than that of a typical bank, whose assets consist primarily of much less liquid loans.

The more recent arguments for repealing the GLB Act—and for reinstating Glass-Steagall—do not seem to have much to do with safety and soundness or with the causes of the 2008 financial crisis (334). Rather, those making the arguments seem to fear the excessive concentration of assets and lending power in a few large banks that also have investment banking affiliates. Thus, the urge to break up the banks is a call to not only literally break up the commercial banking units but also, in the interest of deconcentrating the financial system, force their separation from their investment banking sisters or affiliates.

The fear of excessive concentration seems to have several strands, none of which in my personal view justify reinstating Glass-Steagall, although they may call for other policy responses. (The following views are my own and clearly do not purport to represent those of the Shadow members, although I suspect many of them would agree.)

One reason why large commercial and investment banks are feared is due to their perceived political power, exercised through their campaign contributions and their hold on their supervisors ("regulatory capture"). Regarding campaign contributions, it is very likely that large banks or other financial institutions, directly or through their employees, can have outsized impacts on the voting behavior of House and Senate members representing the places where they do business, but in this respect, they are no different than any other type of large company. Their impact on presidential races is much more diluted because there are so many other sources of funds for candidates, their political parties, and independent political action committees.

In any event, however much political influence large financial institutions may have is unrelated to any combination of their commercial and investment banking activities. J.P. Morgan, Citibank, and other large banks with very large balance sheets would have substantial political influence even if they were required to separate from their investment banking arms, and vice versa with Goldman Sachs and Morgan Stanley, if they were forced to divest their smaller banking affiliates.

Regulatory capture by large financial institutions of the regulators that oversee them is a more legitimate concern, in my view, and one that many academic scholars have criticized over the years. Since the 2008 crisis, the capture problem has been mitigated by much tougher supervision and higher capital requirements, especially for banks with assets exceeding $50 billion, which are automatically designated under Dodd-Frank as systemically important. Many community and regional banks, however, have argued that the supervisory reaction to the 2008 crisis has been overdone, or at the very least undifferentiated: a one-size-fits-all supervisory approach that fails to take account of size and other differences among banks.

It bears emphasis that this latter critique, one with which I and others in Congress have some sympathy, actually is not an attack on Dodd-Frank, as it sometimes is portrayed in the political arena, but rather an objection to the way bank supervision is carried out.

In any event, the key point is that for some time in the wake of the latest crisis, the regulatory capture critique of large banks was not on target, although I admit it could resurface down the road as memories of the 2008 crisis inevitably dim among banks and their overseers.

Many community and regional banks have argued that the supervisory reaction to the 2008 crisis has been overdone, or at the very least undifferentiated: a one-size-fits-all supervisory approach that fails to take account of size and other differences among banks.

The regulatory capture problem may have once been more serious when there were stand-alone investment banks, because their safety and soundness was overseen by the Securities and Exchange Commission (SEC), an agency whose mandates under Dodd-Frank have been greatly expanded while its resources have not, and whose expertise so far has not been in safety and soundness oversight. But regulatory capture is now much less of a problem for the two largest investment banks—Goldman and Morgan Stanley—which in the middle of the crisis converted to bank holding companies and thus are subject to Fed oversight. Presumably, the Fed has or will use this authority to take a tougher look at the capital and liquidity positions of the securities subsidiaries than would otherwise be the case if only the SEC were in charge. But even if this were not the case, any capture issue relating to safety and soundness oversight of investment banks is not worsened by their affiliation with commercial banks and may actually be ameliorated to some extent due to the Fed's participation in the supervisory process (a development that predated Dodd-Frank).

Another concern about excessive concentration in the banking industry—and the relative growth of large banks in particular—stems from the view that, other things being equal, smaller community banks are more likely to make character loans and thus more likely to finance entrepreneurial ventures. Therefore, as the share of banking assets held by smaller banks declines, the banking industry as a whole arguably is less likely to support innovation and entrepreneurship.

While there may be some truth to this critique—lending by large banks in particular is down over the past decade—since the crisis, bank examiners have made character lending from *all banks* much more difficult. Moreover, even before the crisis and since, to the extent banks finance entrepreneurial ventures, it has not been done directly, but through entrepreneurs tapping their credit card or home-equity lines of credit, both of which have been tightened since the crisis. (Other sources of entrepreneurial finance are equity infusions by friends and family.) Whatever differences may exist between the largest banks and other banks in lending to smaller businesses and startups, the affiliation of commercial with investment banks authorized by the GLB Act (and earlier regulatory rulings by the Fed) has had nothing to do with the availability of financing for startups and smaller companies that lack collateral.

Finally, the fact that large commercial and investment banks may be affiliated in a common enterprise does not make them any more TBTF than they may be as individual institutions. For example, as the multiple memoirs of the key Fed and Treasury officials during the 2008 financial crisis make amply clear, those officials were extremely worried about the spillovers to both the financial and real economies of the failures of Bear Stearns and Lehman Brothers (only one of which the authorities "saved" via a merger with a stronger institution), even though both institutions had no affiliation with a bank. Likewise, forcing each of the large banks that now have investment banking affiliates to divest them will not make any of the banks less systemically important.

In sum, none of the supposed rationales for reinstating Glass-Steagall do anything to provide substantive support for what has become nothing more than a symbolic gesture. In Chapter 15, I discuss a related proposal, breaking up large TBTF banks themselves, whether or not they are affiliated with an investment bank. It turns out that this idea is already beginning to be implemented—by the banks themselves—although critics want to push it much further along, more quickly.

Notes

1. Notably, the Citi acquisition was inconsistent with the Bank Holding Company Act, not the Glass-Steagall Act—until the passage of the GLB Act. In any event, in 1998, before the Citi-Travelers merger was consummated, the Committee stated it would not pose antitrust risks, because Citigroup and Travelers were in different product markets, nor would it put the FDIC deposit insurance safety net at risk, given that Travelers would be (and later was) housed in a separate nonbank affiliate (147). As for objections that the merger would cement or aggravate TBTF concerns, the Committee argued that this problem could be met by requiring large banks (belonging to diversified holding companies) to issue uninsured subordinated debt to ensure market discipline. This suggestion was never strictly followed, but had it been otherwise, perhaps the concerns about TBTF following the 2008 financial crisis would not have been as loudly expressed as they have been in recent years.

2. Since I began drafting this book, a remarkable, although provocative, new book has been published by former Treasury official and current Vanderbilt Law Professor Morgan Ricks, which persuasively (at least to me) argues that the root of the financial crisis lies in the very large run-up in privately issued uninsured short-term (or "runnable") debt by investment banks, money market funds, and other nonbank lenders. Ricks has some bold prescriptions that go beyond anything that the Shadow recommended during its history and further than any financial reform proposals that, of this writing, are being discussed. But his analysis is very much in the spirit of what the Shadow Committee has been writing for several decades, and his logic and analysis are impeccable. See Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* (Chicago: University of Chicago Press, 2016). For a similar analysis, with a different policy prescription, see Hal S. Scott, *Connectedness and Contagion: Protecting the Financial System from Panics* (Cambridge, MA: MIT Press, 2016). Scott was a member of the SFRC for many years. His book, too, was published after the initial draft of this manuscript had been completed.

VIII. The Importance of Transparency: Financial Reporting and Credit Ratings

Finance can be and often is complex, difficult to fully comprehend for not only users of financial services but oftentimes even investment professionals. Yet comprehension is essential in finance at many levels.

Financial understanding is important for individuals in their own financial affairs, to maximize their wealth and avoid pitfalls associated with imprudent borrowing and investment. It is crucial for companies in all industries, including all types of financial-service companies, to maximize profits and minimize the risk of failure. Creditors and shareholders must understand finance to make prudent decisions about where and under what conditions to deploy their capital and to monitor the performance of the companies or institutions they lend to or invest in.

Key to financial understanding is transparency in financial reporting. Since 1973, standards for financial reporting have been governed in the United States by the Financial Accounting Standards Board (FASB), which has a well-established process for issuing accounting rules. The International Accounting Standard Board also sets global accounting rules, the International Financial Reporting Standards (IFRS). There continues to be tension between these global rules and national rules set by such bodies as the FASB, a topic that the Shadow Committee addressed on several occasions, as discussed in Chapter 14.

The 2008 financial crisis underscores the importance of transparency to not only individual participants in the financial system—borrowers, savers, and lenders—but also the system as a whole. Too many subprime loans were taken out by too many borrowers who either did not understand the risks they were taking or lacked sufficient experience to know that housing prices would not indefinitely rise, thereby making it impossible at some point to refinance their mortgages when the typical two-year period of low teaser rates expired. Too many investors did not understand the opaque mortgage securities that were backed by these subprime mortgages, putting their trust—wrongly as it turned out—in the ratings assigned to these securities by the major credit ratings agencies. Even banks could not trust the financial soundness of other banks due to the opacity of their balance sheets weighed down by too many securities backed by subprime mortgages. The result was a financial crisis in September 2008, after the federal government rescued Fannie Mae, Freddie Mac, and AIG, while Lehman Brothers, a major investment bank, was allowed to fail.

One important set of institutions created to facilitate investors' assessments of risk—credit ratings organizations (or as they are often referred to, agencies)—also unintentionally contributed to the 2008 crisis by giving investors a false sense of comfort through excessively optimistic ratings assigned to securities backed by subprime mortgages. Early on, the Shadow Committee recognized a structural flaw in the ratings organizations' business model and the way they were regulated.

Shadow Statements

As discussed in earlier chapters, one of the Shadow Committee's objections to the risk-based capital standards set initially by central banks in the United States and the United Kingdom and later by the Basel Committee was those standards' failure to measure bank capital according to the market value of banks' assets and liabilities rather than historical costs. In February 1988, the Committee endorsed an FASB proposal requiring all companies, including depository institutions, to annually estimate market values on their financial assets, although not necessarily to report such values on their balance sheets but instead as supplementary disclosures (30). Three years later, the Committee endorsed a similar FASB proposal (69). In 1993, the Committee objected to a bank regulators' proposal to limit the development of fair-value accounting to only financial assets, neglecting to apply the concept to other bank assets and liabilities (95).

Applying market-value accounting to banks and thrifts is still a matter of some contention, however, because a good portion of their assets consists of loans that are not readily traded and thus have no precise market value. In addition, during a financial crisis such as the one in 2008, requiring depositories to mark many of their illiquid assets to market may have caused some institutions to be technically insolvent, even though that would not have been true after the crisis passed. Bank regulators used this rationale to exercise regulatory forbearance in the case of the nation's largest banks during the 1980s less-developed countries (LDC) debt crisis, and as I have noted earlier, it worked.

In light of the 2008 crisis, my own current view—which is different from the Shadow's—is that it is appropriate for depository institutions to be required to report both their financial assets and liabilities adjusted for current interest rates for public reporting and regulatory purposes, but unless these assets have a liquid market, their current values reflecting credit risk (or the risk of nonpayment) need not be reported. This is a bit different and more aggressive than the current accounting rules, which require full market-value accounting only for financial assets held in trading accounts and disclosure through other means (such as in financial statements) of the market values of financial assets held to maturity. When this latter concept was proposed as FASB Rule 115, the Committee endorsed it in May 1994 as a step toward full market-value accounting (109).[1] Making an interest-rate adjustment for loans, as I suggest, is straightforward and need not force otherwise-healthy institutions into insolvency during a financial crisis, or a spike in interest rates that may precede it, because *both* sides of the balance sheet would be adjusted for this purpose.[2]

Meanwhile, at various times, the Committee opposed efforts by Congress or regulators to interfere in the accounting for loans or bank investments in ways that were inconsistent with prudent accounting principles: regarding loans to LDC debtor countries at the end of the 1980s (46) and thrifts holding "junk" bonds around the same time (47). In the same vein, the Committee opposed the FDIC's efforts in early 1990 to arbitrarily cap the amount banks and thrifts paid for mortgage servicing rights—a frequently traded asset—in their reported capital (52).

More recently, in September 2009, by which time much debate centered on whether banks should report for accounting purposes their assets and liabilities at their market values, the Committee recommended that bank accounting for regulatory purposes be separated from accounting for reporting purposes (278). This would not compromise reporting for investors, while allowing regulators to be sensitive to temporary disruptions in market valuations for certain assets. As such, the statement straddles a fine line between forcing institutions whose mortgage securities may temporarily have been depressed in value into the arms of the FDIC and trying to avoid the mistakes thrift regulators made in the 1980s when they allowed really insolvent thrifts to hide their condition with artificial regulatory accounting principles.

The lack of transparency in financial reporting more broadly became a major public concern with the spectacular failures of Enron, Tyco, WorldCom, and other large public companies in the early 2000s. Early after Enron's failure in particular, Congress was considering legislation—ultimately the Sarbanes-Oxley Act (SOX)—designed to prevent future events like this.

In February 2002, the Committee initially was skeptical of two specific ideas that eventually were incorporated in the enacted legislation (178). First, the Committee argued that prohibiting auditing firms from also providing consulting services would sacrifice economies between the two activities without an offsetting justification. Firms engaged in auditing alone with big fees at stake have no more of a conflict of interest than firms offering both auditing and consulting services.

The lack of transparency in financial reporting more broadly became a major public concern with the spectacular failures of Enron, Tyco, WorldCom, and other large public companies in the early 2000s.

Second, the Committee noted that the Securities and Exchange Commission (SEC), which typically had no accountants as members, is just as independent an overseer of the accounting profession as any entirely new regulatory body, which SOX eventually created: the Public Company Accounting Oversight Board (PCAOB). Although established as a private, nonprofit company, the PCAOB was given the authority to finance its activities by assessing a fee on public companies in proportion to their market capitalization. Two years after the PCAOB's creation, the Shadow Committee still saw no reason for its continued existence (215).

There is irony relating to SOX and the new entity it created to improve transparency in financial reporting. In its May 2002 statement about the accounting scandals, the Committee criticized the SEC for not adequately overseeing accounting firms, observing that Arthur Anderson had failed to ensure appropriate accounting for the Special Purpose Entities that Enron had sponsored and whose debt the company had guaranteed, but whose assets and liabilities nonetheless were not reported on Enron's balance sheet (180). Yet much the same kind of failure occurred in the events leading up to the financial crisis of 2008, or well after SOX was enacted and the PCAOB had been in place.

Especially noteworthy is that large banks that had created ostensibly off-balance-sheet structured investment vehicles (SIVs) that warehoused large amounts of subprime mortgage-backed securities were permitted by their accounting firms and regulators to keep these SIVs off the banks' books. When the SIVs ran into trouble, their sponsoring banks for reputational reasons absorbed the SIVs' assets and liabilities. This step so weakened some banks that eventually all of the top nine were compelled by the Treasury Department to accept Troubled Asset Relief Program (TARP) funds to keep them, and the financial system, afloat.

The TARP recapitalization happened only after the Treasury proposed in late 2007 to create a super SIV, backed by the banks themselves, which failed to gain traction. The Shadow Committee predicted this outcome, highlighting several structural problems with the proposal (252). One in particular was the impossibility of fairly assessing the prices of the securities that the super SIV—formally labeled the Master Liquidity Enhancement Conduit (M-LEC)—would acquire from each of the bank-sponsored SIVs. This same problem plagued the initial Treasury plan in the fall of 2008 for the use of TARP funds. The Treasury quickly turned instead to injecting capital into the nine largest banks and many other smaller capital-short institutions. More details about the financial crisis and policy responses to it will be provided in Chapter 13.

Another of SOX's most controversial provisions, Section 404, requires independent auditing firms to examine a public company's internal controls to manage risk. In 2005, the Committee noted that companies' costs of complying with this provision were much higher than anticipated. Accordingly, the Committee recommended a benefit-cost analysis to determine whether Section 404 should be modified or retained (219). Indeed, the Committee suggested that *ex post* cost-benefit analyses be required for other types of legislation whose costs and benefits are difficult to assess in advance.

In 2007, the Committee sided with two reports expressing alarm over the declining international competitiveness of US capital markets due to regulatory and litigation costs, but it focused its main criticism on the costs of private class-action lawsuits for misrepresentation arising under the SEC's Rule 10b-5, which the Committee urged to instead be enforced solely by the SEC. The Committee nonetheless supported class actions for insider trading (242), but later urged Congress to limit accounting firm damages to a multiple of their audit fees, while exposing individual auditors to disciplinary penalties (247).

As noted earlier, many poorly rated mortgage-backed securities fueled an unwarranted expansion in subprime mortgage credit, which contributed to the 2008 crisis. But this was not the ratings organizations' first failure. In December 2002, the Committee noted that these agencies had failed to predict the collapses of Enron and other notable public companies. As one remedy, the Committee urged the SEC to liberalize entry into the ratings business, which would lower costs for issuers and investors and enhance innovation in the ratings marketplace (183).

While I personally agreed with this recommendation at the time, and still do even as the SEC since has seemed to take this advice to heart, I am under no illusions that more competition in ratings would have prevented the ratings mistakes that facilitated excessive securitization of instruments backed by subprime mortgages. That error is traceable largely to the fact that issuers pay for ratings, a circumstance that is difficult to change given the marketplace's inability to support ratings financed by investors, since information leaks out too quickly to other investors who can free ride on those who initially might pay.

I am under no illusions that more competition in ratings would have prevented the ratings mistakes that facilitated excessive securitization of instruments backed by subprime mortgages.

In December 2008, once the financial crisis was under way, the Committee recommended several reforms to improve the credit ratings process: (1) enhanced disclosure of the methodology the ratings organizations use, which would allow independent experts to assess the ratings' quality; (2) removal of multiple requirements that limited financial institutions to investing in only highly rated financial instruments, which increases pressure on the ratings agencies to artificially inflate their ratings; and (3) imposition of penalties, including suspension of the SEC's Nationally Recognized Statistical Rating Organization status, on ratings firms whose ratings prove too optimistic (265). The Committee argued that the SEC's failure to adopt these reforms represented a missed opportunity—a circumstance that remains true to this day. Later, in May 2011, the Committee expressed skepticism that increased regulation of the ratings process would be effective (314), a view that I share.

Where Things Now Stand

Accounting and financial reporting issues may not be the stuff of headlines as they were in the early 2000s, but tensions remain between those who advocate for continued use of US accounting rules and those who believe that IFRS ought to replace them.

Likewise, the credit ratings system will continue to be flawed as long as the ratings are paid by issuers, a situation that may be difficult or impossible to change in this era in which financial information is available almost everywhere to everyone virtually instantaneously. This being the case, the continued existence of ratings cannot and should not relieve regulators and investors of exercising their own due diligence when assessing the financial soundness of financial institutions and instruments.

Notes

1. When the thrift and bank regulatory agencies proposed in December 1994 to not count in their capital calculations changes in market values of securities held for sale, the Committee objected (112).

2. During the crisis, the Committee issued a nuanced statement that broadly supported the use of market-value accounting but recognized its limitations during times of distress, when markets for particular assets may be illiquid and prices may not reflect their true long-term value (266).

IX. Trading in Financial Instruments: Securities and Derivatives

No country or financial market has escaped sometimes-large volatility in stock prices and occasional stock price collapses. The stock market crashes that began in 1929 and continued for several years thereafter are of course the most well-known to most Americans. But as readers of this book surely will remember from the crash in late 2008 through early 2009, such episodes have not gone away.

The Shadow Committee had been in business for only a little more than a year when the largest one-day stock market crash since 1929 occurred—the roughly 20 percent decline in stock prices on October 19, 1987. That the market quickly rebounded somewhat the following week and the wider economy continued its upward march until the recession of 1991–92 did not erase the memories of the fear that pervaded America that October day.

The Shadow Committee addressed multiple securities-related public policy issues throughout its tenure, not just those that grew out of the October 1987 stock market crash. High on the list was the urge to better coordinate prices of stocks in the cash markets and those for stock futures (contracts tied to stock prices in the future) and to do something about portfolio insurance's failure to protect against the crash in stock prices.

Eventually, interest in the October 1987 stock market crash and securities issues receded, only to resurface in the early 2000s with the failures of several formerly high-profile companies, especially Enron and WorldCom. These companies were driven over the financial cliff by their CEOs and top managers who had been strongly encouraged by large stock-options compensation packages. The result was the passage of the Sarbanes-Oxley Act (SOX), which, as discussed in Chapter 8, enacted new disclosure requirements and penalties for noncompliance for public companies and their CEOs and prohibited accounting firms from doing consulting work for the same clients. Despite overwhelming support in Congress for passing the act, SOX quickly became controversial in the entrepreneurial and business communities. The Shadow Committee weighed in with several statements relating to the act, both before and after its enactment.

Other securities-related issues also attracted the Committee's attention: concerns about alleged short-termism of public companies; issues relating to the adequacy of corporate governance; periodic worries about short selling when stock prices declined; issues regarding mutual funds; arguments about rules governing stock trading and the structure of exchanges, especially as the once-dominant position of the New York Stock Exchange (NYSE; since purchased by a relative newcomer to the exchange business, the Intercontinental Exchange) eroded in the face of strong competition from other technology-based exchanges; and the debate over new rules for young companies seeking capital, culminating in Congress' passage in 2012 of the Jumpstart Our Business Startups (JOBS) Act.

Finally, perhaps the most controversy relating to public policy toward any financial instruments, at least since the financial crisis of 2008, has been around the regulation of derivatives: financial contracts whose value is "derived" from underlying securities or instruments. Well-known examples of derivatives are options and futures contracts on commodities and later on stocks and stock indexes. These contracts typically are standardized, like their underlying instruments, and are traded on exchanges, which are supervised by the Commodities Futures Trading Commission (CFTC). The trading and regulation of these well-known financial instruments for the most part has not been controversial, except during episodes when the prices of the indexes and their underlying securities have gotten hugely out of line, the prime example being the "Flash Crash" of 2010.

The central problem with CDS was not the nature of the contract, but that some parties (most famously, AIG's Financial Products Group) issued these instruments without posting sufficient margin or collateral to guarantee payment.

Much more controversy and debate, in contrast, have centered on the opposition of key Clinton administration officials in the 1990s (except for CFTC Chair Brooksley Born) and later of Congress to regulation of over-the-counter (OTC) derivatives: more customized instruments that inherently cannot be traded on exchanges because they are not standardized, and thus whose purchase and sale typically are conducted by financial institutions acting on behalf of mostly sophisticated customers who want to trade in these instruments. By trading volume, the most heavily traded OTC derivatives are interest-rate swaps, contracts that exchange different streams of income between parties (for example, exchanging interest on loans with fixed interest rates for interest on loans for which the rates vary by market conditions).

However, through the 2000s, one of the more rapidly growing OTC derivative contracts was the credit default swap (CDS), which essentially insured buyers against losses on loans. Investment companies and other parties extensively used CDS in constructing complex securities backed by subprime mortgages and other loans. These collateralized debt obligations, as they came to be known, were typically split into different parts, or "tranches," with the income streams paid first to the safest tranches, and then in sequence to the riskier tranches. CDS contracts were typically used to cover the risk of the safest tranches to secure the highest ratings from the ratings agencies. In many popular accounts of the 2008 financial crisis, CDSs receive much of the blame.

The central problem with CDS was not the nature of the contract, but that some parties (most famously, AIG's Financial Products Group) issued these instruments without posting sufficient margin or collateral to guarantee payment. Under the Commodity Futures Modernization Act of 2000, the CFTC was explicitly denied authority to require the posting of such margin on OTC derivatives contracts involving "sophisticated parties."

This rich diet of topics relating to the trading of conventional securities and more exotic derivatives will be on the menu in this chapter.

Shadow Statements

The Committee's first entry into the securities-related policy arena was in November 1987, shortly after the October 19, 1987, stock market crash, when the Committee cautioned against a quick rush to judgment on reforms that were then being considered by the Brady Commission, which the Reagan administration formed to report within 60 days on the crash's causes and to suggest regulatory changes in response to them (23). Several months later, the Committee issued a statement faulting six studies that by that time had studied the crash and come up with policy proposals but failed to make a convincing argument for why any of these ideas would have prevented the October 1987 crash, which the Committee suggested was due instead to fundamental economic factors (26).

One very specific Committee statement rejected arguments that the crash was caused by the arbitraging of stock index futures and stock prices and that this claim justified regulating arbitrage activity or banning stock index futures (33). The Committee noted there was no evidence that futures transactions caused the crash.

In December 1989, the Committee criticized the exchanges adopting circuit breakers (temporary trading halts prompted by sudden deep drops in stock prices), another idea for which the Committee suggested there was no evidence of effectiveness, pointing to the failure of such breakers to halt the stock market's decline in October 1989 (51). The Committee was unsuccessful in persuading the exchanges or regulators to reject circuit breakers, which since have been maintained and refined. However, efforts to ban or heavily regulate stock index futures and their use in arbitrage and hedges against investor risks in the cash market were never adopted, consistent with the Committee's advice.

From time to time, regulatory reformers have proposed that the two federal agencies that regulate the securities and financial derivatives markets, respectively, the Securities and Exchange Commission (SEC) and the CFTC, be consolidated, to achieve efficiencies and prevent market actors from exploiting differences in regulation of similar financial instruments driven solely by differences in labeling (as securities or derivatives). The conventional political-economic argument as to why this will never happen is that because the two agencies are overseen by two different committees in each congressional chamber—Banking or Financial Services (for the SEC) and Agriculture (for the CFTC)—neither committee will ever cede its turf to the other, or even jointly oversee a consolidated SEC/CFTC (an arrangement that would be cumbersome). To this political reality, the Shadow Committee in May 1990 added a more substantive note of caution about such a regulatory merger: the danger of monopoly regulatory power within one agency. Indeed, the Committee speculated that had one agency instead of two governed the market in financial instruments, futures trading of all kinds most likely would never have been approved (57).

In 2000, in a substantive matter relating to CFTC regulation, the Committee supported the position Congress ultimately took in enacting the Commodities Futures Modernization Act of 2000: that OTC derivatives transactions between "sophisticated parties" should be exempted from CFTC regulation as futures contracts (163). The statement reflected the prevailing presumption at the time among many economists, including Federal Reserve Chairman Alan Greenspan and Treasury Secretary Lawrence Summers, that contract law was sufficient protection for entities such as banks, hedge funds, and large corporations that used OTC derivatives. This is one clear case where, at least in my opinion, the Shadow Committee erred. I discuss this mistake more fully in my counterfactual history in Chapter 15.

The Committee also weighed in occasionally on other securities-related topics. One of those concerned disclosure policies relating to mutual funds. In December 2002, the Committee not only endorsed the SEC's proposal (which was ultimately adopted) requiring mutual fund companies to report their portfolio compositions quarterly instead of semiannually, but also urged more frequent disclosures, on a monthly basis, which the Commission has not yet adopted (184). The Committee argued that the benefits to investors generally of more frequent transparency outweighed any costs to the mutual funds or their investors.

A related statement, issued in December 2003, applauded congressional efforts at enhancing the transparency of mutual fund expenses and toward that end urged that "soft dollars" for research—commissions paid in excess of actual transactions costs—be included in reported expense ratios (200). Three years later, in 2006, the Committee urged that regulators require broker-dealers to break out separately commissions charged for trade execution and soft-dollar charges for research, in the interest of transparency for investors (228), which to my knowledge the Commission has not acted on. In a similar vein, the Committee supported a 2004 SEC proposal to prohibit investment management companies from directing execution of trades to brokerages in exchange for sales and support of management companies' mutual funds (206).

The Committee argued that the benefits to investors generally of more frequent transparency outweighed any costs to the mutual funds or their investors.

Securities regulators also concerned themselves with another form of collective investment activity: hedge funds, or managed investment pools for wealthier investors that take both long and short positions in equities and many other financial instruments. In response to reported concerns relating to the rapid growth in monies invested in hedge funds, the SEC proposed in 2003 that they be registered as "investment advisers." The Shadow Committee opposed the proposal, pointing to the low level of fraud in the industry and arguing that registration would not correct these abuses if indeed they were a problem (210). In May 2007, however, the Committee endorsed assembling ad hoc panels of independent experts to examine the causes of failures of large hedge funds, much like the Federal Aviation Administration's panels of safety experts who study airline crashes. The postmortems inform future policies to help ensure that events like these do not happen again (244).

Eventually, hedge fund advisers were brought under the SEC's regulatory umbrella as part of the Dodd-Frank Act, but not to address fraud: the purpose then and still is for regulators to be aware of the funds' risk profiles so as to better gauge any systemic risks their investment activities may pose. But even this tilt toward more regulation was somewhat offset two years later, when Congress in the JOBS Act made it easier for hedge funds to solicit investors.

The Committee wrestled from time to time with the age-old question of whether and to what extent federal regulatory policy in the financial sector should coexist with (as it has in banking) or preempt state regulation. In December 2003, the Committee supported federal preemption in the case of the investigation by New York State Attorney General Eliot Spitzer, on behalf of several other states, against major securities firms for abuses relating to their investment recommendations, an action that ultimately resulted in a broad settlement that fundamentally changed recommendation practices (186). The Committee noted that the state investigations filled a void left by SEC inaction, but argued that enforcement actions by individual states were inconsistent with the national nature of the securities market.

The Committee also on several occasions opposed the SEC's attempts to limit or prohibit short selling (188, 261, 274), a position securities regulators in other countries occasionally advocated too, especially during market downturns. Short sellers attract regulatory attention and opprobrium because they profit at times when others are in financial distress. But visceral opposition to short sellers overlooks their benefits to markets: they help keep the prices of individual stocks and equities in general from becoming artificially inflated, while adding liquidity to markets by strengthening their sell side when others want to buy. Cases in which short sellers act collusively to manipulate the market are another matter, and the SEC should police them rather than banning or limiting short selling.

In May 2009, the Committee specifically came out against an SEC proposal to reinstate restrictions on short selling, which had been lifted in 2007 (274). During that two-year period, the Committee pointed out, independent economists who had studied this experiment found no evidence that the short-sale restrictions actually reduced short interest; rather, they distorted the trading process.

In 2003, the SEC took small steps to make it easier for public companies' shareholders to nominate directors and communicate with management and boards. The Shadow Committee suggested these steps were symbolic and argued instead that the SEC's real focus should have been on making it easier for large shareholders in particular to play a meaningful role in corporate control contests and oust unproductive corporate managers (199). The Committee reinforced this theme the following year by urging a reexamination of rules or laws that make it difficult for institutional investors in particular (such as those limiting shareholdings by institutional investors in a single company) to play a more active role in corporate governance (204).[1]

In September 2003, the Committee also supported several measures the NYSE was then considering to make its directors and management more independent of floor brokers (201). The statement even suggested the radical notion at the time that the shares in the exchange become publicly held. Replacing humans with computers in all major equities exchanges has made these suggestions somewhat anachronistic, as has the acquisition of the NYSE itself by the once-upstart Intercontinental Exchange. But the Committee was ahead of its time in urging that the exchange business be brought into the modern era, an outcome eventually driven by technology.

One of the more controversial SEC rules of recent times was its Regulation National Market System (NMS). This complicated 2004 proposal suggested that its trade-through rule, which prohibited execution of trades on any exchange that were inferior to a quoted price on another exchange, be extended to trades on NASDAQ (which was not a recognized exchange), with some carve-outs in certain special situations. The trade-through rule prevented other exchanges from offering faster execution, even at inferior prices.

The Committee was an early opponent of Regulation NMS and argued in May 2004 that the SEC should first decide what kind of market structure in equities it wanted: a single, centralized system that would maximize liquidity but could inhibit innovation or a more fragmented, competitive system of multiple exchanges (205). The SEC never has made an explicit decision on this question, which the Committee spotlighted again in February 2010 (287), so by default, the equities trading market has devolved into the latter, more fragmented system. This, in turn, spawned the highly controversial rise of high-frequency traders (HFTs), who among other things, have engaged in rapid-fire, automated trading that arbitrages any price differences for the same securities on different trading platforms, however fleeting they may be.

Despite early criticism leveled against HFTs, in its 2010 statement, the Committee supported the SEC

The Committee argued in May 2004 that the SEC should first decide what kind of market structure in equities it wanted: a single, centralized system that would maximize liquidity but could inhibit innovation or a more fragmented, competitive system of multiple exchanges.

in not regulating algorithmic trading but urged the SEC instead to focus on the lack of transparency in the trading of corporate bonds, which the Committee argued hurt retail customers (287). In September 2014, the Committee revisited the equity market structure issue and urged the SEC to disclose to the public more data about aspects of trading on the different markets—such as order routing, execution quality, and differential treatment of customers on different exchanges—so that independent parties would be better able to assess whether regulatory refinements were necessary (353).

In February 2005, the Committee restated its objections to the SEC's modified trade-through proposal, claiming it would impede competition among exchanges to the detriment of investors (217). The Committee supported instead a proposal by the then-NYSE that would have permitted the execution of trades of NYSE-listed stocks on other trading venues, including electronic communications networks that match orders electronically. This idea was eventually adopted and enhanced competition among exchanges (and ironically helped undermine the NYSE's long-standing dominance in exchange trading of equities).

In February 2006, the Committee opposed efforts by the SEC and CFTC to refine margin requirements on two equity derivative products, equity options and single stock futures, preferring instead to allow options and futures exchanges themselves to set these requirements (227). The Committee questioned the usefulness of varying margin requirements to curtail speculation—parties can always borrow through other means—and urged the two agencies to more closely examine margin requirements before making any further changes. (This antiregulatory stance vis-à-vis margins for exchange-based products is not inconsistent with requiring margin for products traded OTC, such as CDS, in which the two parties may not take full account of the social costs of having inadequate margin or collateral).

Not all Shadow Committee statements regarding securities regulation (or other types of regulation, for that matter) have been critical. In May 2006, the Committee applauded several significant steps the SEC took under its relatively new chairman, Christopher Cox: (1) focusing monetary penalties for securities law violations on the culpable individuals rather than on corporations (and hence their shareholders); (2) strengthening disclosure of public company compensation for officers and directors; and (3) making an exception to its trade-through rules (which the Committee has opposed) for one innovative trading platform (231).

One of the more recent legislative and regulatory initiatives the Committee has applauded is Congress' passage of the JOBS Act in 2012 (328). This legislation had several components, including (1) provisions relaxing restrictions on raising capital by emerging growth companies, or those with revenues below $1 billion, as well as Regulation A offerings by smaller companies seeking to raise $5–50 million; and (2) exemptions from SEC registrations for certain crowdfunding transactions. Critics attacked the act for weakening investor protections. The Shadow Committee pointed to investor protections built into the act, as well as its useful rebalancing of such protections against the cost of raising capital. It took three years for the SEC to write rules implementing the crowdfunding provisions of the JOBS Act.

Epilogue: Where Things Stand

At this writing, the SEC continues to wrestle with the critical question the Committee posed more than a decade ago: what kind of market structure in trading of equities (or other financial instruments, for that matter) best balances the liquidity a more centralized structure offers against the innovation a more competitive structure facilitates? I suspect that this debate will continue for some time, and in the meantime it will be decided more by actors and actions in the marketplace than by policymakers in Washington.

Another debate likely to continue is whether the long-awaited crowdfunding rules under the JOBS Act that the SEC finally promulgated in October 2015 will fully achieve the objectives of the bill's sponsors—spurring a large growth in early-stage capital for new companies and ideas—without entailing the risks of fraud and other abuses that opponents of relaxed protections for small investors most feared. In addition, it is a matter of debate how important crowdfunding will be to new companies' capital-raising efforts. As more information about both the benefits and risks of the crowdfunding regulations comes in, the SEC or Congress may adjust the regulatory environment for crowdfunding and for more conventional capital-raising techniques by new companies.

Notes

1. In a related statement issued in December 2006, the Committee expressed concern about the implications of a federal appellate court decision allowing shareholders with as little as 3 percent of total shares outstanding to nominate directors (237). The worry was (and remains) that with such a low shareholding threshold, very narrow interests can divert companies from their main function, which is to maximize returns for all shareholders.

X. Pension Guaranty Issues

The Federal Deposit Insurance Corporation's (FDIC) bank deposit insurance program is not the only government-created guarantee system for financial assets. Congress has also created a fund to protect securities investors against losses (up to $500,000) from the failure of their brokers, the Securities Investor Protection Corporation, and the Pension Benefit Guaranty Corporation (PBGC) to ensure that beneficiaries of private defined benefit plans receive their promised retirement benefits (up to about $55,000) if the sponsor of those plans, individual companies or multiple employers, fail or cannot afford to pay those benefits. The states also have created guaranty funds for insurance policyholders in the event insurers fail.

In addition to these institutional guaranty funds, the federal government (through the Federal Housing Administration) or privately owned entities created by the government (i.e., housing government-sponsored enterprises) guarantees mortgages for qualifying homeowners with incomes or mortgages below certain ceilings, insures individuals against losses from floods, insures some student loans, and insures farmers for crop loss from a variety of natural causes.

In each of the federal programs, insurance customers pay an *ex ante* premium, just as they do for privately supplied insurance. State guaranty funds for insurers are different: they operate on an *ex post* basis and make assessments (up to an annual limit) on surviving insurers in the state when insurers fail.

In the case of privately supplied insurance, the market, along with regulators whose degree of oversight varies by state, helps ensure that the premiums charged are actuarially sound. In contrast, administrators of government-run insurance and guaranty programs are subject to political pressures, either directly or from congressional overseers, to keep premiums below actuarially sound levels and avoid charging risk-based premiums, as is done in the private sector. That is why these government funds can run into financial trouble. We have seen this with the FDIC and the flood insurance program.

It may surprise some readers, but similar pressures have long plagued the PBGC, the fund protecting retirees. The Shadow Committee first weighed in on the PBGC's funding difficulties in the early 1990s, and it occasionally returned to the matter on other occasions. After the 2008 financial crisis, the Committee also addressed the growing crisis of underfunded municipal and state government pension funds.

Shadow Committee Statements

In March 1993, the Committee referred to studies by two analytical arms of Congress, the Congressional Budget Office and the General Accounting Office (now the Government Accountability Office), that estimated that the PBGC was insolvent, one on the basis of book-value accounting and the other on more realistic current values, which more accurately account for expected future payouts. The Committee highlighted companies' incentives to underfund defined benefit plans and pressures by labor unions for perhaps unrealistically high pension benefits for their members—with both employers and unions knowing that if the plan sponsor failed, the PBGC would be there to pick up most or all of the tab (93).

While the Committee at that time did not offer a detailed reform agenda, it outlined several reform principles for the new Clinton administration to adopt, including better risk monitoring; enhancing priority of the PBGC in bankruptcy proceedings, so that not all risks are not shifted onto the PBGC and ultimately taxpayers when companies fail; and prohibiting firms with underfunded plans to increase benefits, while requiring them to abide by tight timetables to correct their underfunding. In September 1993, the Clinton administration adopted two of these measures: higher premiums for covered benefit plans and limits on underfunded plans to grant additional benefits. The Committee endorsed these steps in December of that year (102).

The PBGC's underfunding problems were more severe a decade later after the 2001 recession, prompting the Shadow Committee to again weigh in with a statement in September 2003. The Committee urged the adoption of risk-based premiums and a requirement that firms immediately begin funding benefits to employees in plants that will shut down, rather than wait until the actual shutdown occurs (198). The Committee repeated its warnings about the potential for a taxpayer bailout of the PBGC if it did not immediately implement certain major changes in its insurance program, such as the use of more realistic, lower interest rates to discount future pension liabilities (208, 213). Even at this writing, in late 2016, concerns remain about the adequacy of reserves at the PBGC to cover future losses from its insurance of defined benefit plans.

The PBGC is not the only entity facing underfunding problems. Many municipalities and states for years have underfunded their government employees' defined benefit pension plans. In February 2011, the Committee pointed to three of the (now) widely known reasons for this state of affairs: overly generous benefit promises by political leaders, unrealistically high discount rates used to determine the present value of the plans' future liabilities, and state and local governments borrowing from these plans to fund general operating expenses (310). The Committee urged public plans to immediately adopt funding requirements and self-dealing restrictions applicable to begin remedying these problems. So far, those recommendations do not appear to have been widely adopted.

XI. Housing Policy Issues

While the Shadow Committee did not wade into housing policy in depth during its three decades, it did pay particular attention to housing finance, especially the role of the Federal Housing Administration, which insures mortgages for low-income borrowers, and three of the five major government-sponsored enterprises (GSEs) created to facilitate credit flows into housing: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBB).[1]

Fannie Mae and Freddie Mac were established to create a secondary market for mortgages originated primarily by thrifts and later by banks. In 1992, Congress began to also require the GSEs to meet affordable housing goals, namely to hold or guarantee mortgages for low- to moderate-income homebuyers. The goals, expressed as a percentage of the GSEs' overall financing activities, were increased in both the 1990s and 2000s—an idea that had good intentions, but eventually backfired by facilitating excessive subprime lending in the run-up to the 2008 financial crisis.

The FHLBB was created to be like a Fed for depository mortgage lenders, providing credit primarily to thrifts to assure their liquidity. Its operations have been less controversial than those of Fannie and Freddie, whose hybrid nature—private ownership paired with public purposes—has perplexed policymakers for decades.

What is the best way to promote home ownership without posing excessive risk to taxpayers? The latter half of that question became more than a hypothetical when both GSEs had to be put into conservatorship during the height of the financial crisis in September 2008.

The hybrid nature of the housing GSEs creates several tensions—some would say problems. One tension is between their privately held status, which obligates management to maximize returns to shareholders, and their public mission of facilitating affordable housing, which has encouraged the firms to take additional risks or accept lower profits.

Another tension involves the distortions in credit markets introduced by the GSEs' presence. Because of their public mission and because their balance-sheet and off-balance-sheet guarantees are large—collectively totaling more than $5 trillion—creditors have long assumed that in a crunch the federal government would pay off the GSEs' debt in full. In effect, the marketplace has treated GSE bonds as being close to riskless assets, at least regarding credit risk, much like US Treasuries.

This market assumption was validated during the financial crisis when the implicit guarantees of the debt issued by Fannie and Freddie were made explicit when regulators took control of both institutions, placing them into conservatorship (a status they still occupy as of this writing) while imposing no losses on their bondholders. The US government—that is, taxpayers—eventually put in roughly $200 billion into the two housing GSEs to prop them up and keep them going after placing them in conservatorship, effectively under regulatory house arrest, in September 2008. In addition, the Fed has propped up Fannie and Freddie by buying their securities.

Even before these unprecedented events, the implicit guarantees on the housing GSEs' bonds enabled each institution to borrow at interest rates below those charged even to the most creditworthy private borrowers, thus representing an implicit subsidy. Much of that subsidy would have been offset had the two principal housing GSEs—Fannie and Freddie—been held to the same capital standards for banks and to an enforcement regime such as structured early intervention and resolution (SEIR). But that has never happened, even since the financial crisis.

Fannie and Freddie remain in a holding status until the president and Congress can agree on a plan to reorganize them, wind them down, or convert them into a new kind of entity that would still formally support the housing market in some fashion. Since they were placed into conservatorship, Fannie and Freddie have earned sufficient profits to more than repay the US government, but the government continues to hold their shares and take the entities' additional profits. Investors have filed a lawsuit alleging that they, rather than the Treasury, should be the beneficiaries of any future profits now that the federal government's investment has been repaid. This lawsuit remains unresolved as of this writing.

Shadow Statements

The Shadow Committee first issued a statement about these three GSEs in September 1990, noting that their hybrid status enables them to borrow with the implicit backing of the US Treasury, thus lowering their cost of debt relative to other privately held entities (61). Unusually, this credit subsidy becomes more valuable the lower the market value of the companies themselves. Indeed, the Committee noted that the GSEs' market value became negative—along with the entire thrift industry—in the early 1980s when interest rates soared into double digits, yet no steps were taken to put the GSEs out of business or limit their operations.

In 1990 the Treasury Department issued the first of what would be many proposals over the ensuring two decades to prevent a future GSE financial meltdown, which, as the introduction to this chapter noted, proved to be unsuccessful. The department's three-part proposal in 1990 included a requirement that the GSEs obtain an AAA rating from at least two nationally recognized rating agencies, that a new "safety and soundness" regulator for the housing GSEs be created, and that the value of the credit subsidy afforded to the GSEs due to the Treasury's implicit backing of their debt be disclosed annually as part of the president's budget, an idea that the Shadow Committee endorsed in 1996 (131). Each of the Treasury proposals eventually was adopted—although the first suggestion, that the GSEs obtain the highest ratings from at least two ratings agencies, was later discredited by the credit rating agencies' failure to properly assess the credit risk of mortgage-backed securities and collateralized debt obligations backed by subprime mortgages in the mid-2000s.

In September 1991, the Committee urged that the SEIR capital regime, which ultimately would be part of the Federal Deposit Insurance Corporation Improvement Act for banks, be extended to the GSEs, with a sufficiently high capital requirement to eliminate both implicit and explicit taxpayer subsidies (75). Furthermore, the Committee recommended that safety and soundness supervision of the housing GSEs be lodged in an entity other than the Department of Housing and Urban Development (HUD), which would create regulatory conflict of interest, given HUD's mission of promoting housing. Other candidates for the GSEs' regulator included an independent agency, the Treasury, or the Office of Management and Budget.

In May 2001, the Committee was more explicit in endorsing the Treasury as the logical regulator, given that national banks are overseen by the comptroller of the currency, an arm of the Treasury, but it opposed a proposal at the time that would have given the oversight job to the Fed, which also would have authority to expand the housing GSEs' activities, a step the Committee also strongly opposed (171). In fact, an independent regulatory agency eventually was created many years later, but the SEIR regime with a bank-like capital requirement was not. It is not coincidental that both GSEs eventually failed and had to be placed into conservatorship, where they remain at this writing.

The Committee also opposed promoting home ownership indirectly through the bank regulatory system, specifically through the unrealistically low 50 percent risk weight under the Basel bank capital standards applied to mortgage loans and through congressional efforts to sneak into the 50 percent category loans for housing construction and multifamily properties (81). The Committee pointed out not only that the 50 percent risk weight itself was arbitrary but also that any nonmarket-based method for assigning risk weights amounts to government credit allocation, which the Committee opposed. If housing is to be subsidized, it ought to be done directly and transparently.

If housing is to be subsidized, it ought to be done directly and transparently.

Likewise, as early as 1994, the Committee expressed concern about effectively subsidizing home ownership by expanding federal mortgage guarantees from the Federal Housing Administration and from Fannie and Freddie (108). The Committee saw no reason why the government should crowd out private mortgage insurers that are operating without a government subsidy. As I argue in a subsequent chapter, had policymakers heeded the Committee's warnings regarding higher government insurance ceilings, the housing bubble of the next decade would not have grown so large, and thus its bursting (had the bubble occurred at all) would not have been as devastating. In September 2000, the Committee warned that the implicit guarantee of Fannie's and Freddie's creditors meant that they would be bailed out if the institutions themselves became insolvent (164).[2] This is precisely what happened eight years later.

The Committee also urged that in the absence of full privatization of the housing GSEs, some of their special privileges should be eliminated. One of them is an exemption from the Securities and Exchange Commission's registration and disclosure requirements. In September 2003, the Committee noted a federal agency task force's recommendation that Fannie and Freddie disclose more of the composition of securities they guaranteed (189), an idea that the housing GSEs voluntarily accepted. But the Committee also suggested one further step: that the same registration and liability requirements that apply to other private issuers apply as well to securities issued or guaranteed by both GSEs, as would have been required by then-pending legislation. In another statement issued in September 2003, the Committee called on Congress to prohibit or at least limit the housing GSEs from acquiring mortgages or mortgage securities for their portfolios, while taking other steps, such as removing the presidential appointment of directors and the GSEs' access to a line of credit from the Treasury, that reinforced the market impression that Fannie's and Freddie's liabilities were implicitly backed by the federal government (196).

In two later statements issued in 2005, the Committee again restated its preference for full privatization of Fannie and Freddie but expressed "second-best" support for legislative proposals designed to strengthen their safety and soundness regulation, with two provisos: that the legislation require the appointment of a receiver if either one or both became critically undercapitalized and that it cap the size of the GSEs' portfolios (216, 218). The Senate Banking Committee later adopted the mortgage portfolio cap, a move endorsed by the Shadow Committee (221), but it never became law. The Shadow Committee's suggestion that the Federal Housing Enterprise Regulator, the new housing GSE regulator, also have the authority to appoint a receiver for both institutions also was used, although belatedly, in 2008, after Fannie and Freddie already were insolvent. None of the other Shadow Committee recommendations relating to the housing GSEs have been adopted, even eight years (and counting) following the federal rescue mounted after the 2008 financial crisis.

The Committee also expressed concerns about the implicit taxpayer subsidies provided to the Federal Home Loan (FHL) Banks, and it recommended in 1996 their phased transition to pure private ownership, without "Federal" being in the name, as it suggests implicit government backing (134). The Committee pointed to privately owned federal corporate credit unions, which have long played a similar backup financing role for credit unions. It should not be surprising, therefore, that the Committee opposed suggestions that FHLBanks be allowed to accept a broadened range of assets, including small business and rural- and community-development loans, as collateral for FHL loans to its member institutions (144). After the Gramm-Leach-Bliley (GLB) Act, which included such broadened activity powers, was passed, the Committee issued a statement opposing this particular provision and urging its repeal, which never happened (159).

The spark for the financial crisis that would cause so much economic damage in 2008 was the explosive growth of subprime lending, facilitated by the securitization of subprime mortgages. As early as 2001, the Federal Reserve began exploring how to rein in those subprime mortgages that critics were characterizing as "predatory": mortgage loans that lenders tricked vulnerable borrowers into signing. In December 2001, the Committee supported targeted measures to curtail these abuses—specifically, enhanced disclosures, subsidized credit counseling, and narrowly focused regulation—to avoid depriving low-income, minority, or riskier borrowers of access to credit and credit life insurance that they could affordably service (173). In September 2003, the Committee suggested that Congress consider adopting a uniform federal law governing consumer protection more broadly, at least for national banks, which since the Riegle-Neal Act had the ability to branch across state lines to avoid the compliance difficulties associated with 50 potentially different state laws (195).

By May 2007, the subprime mortgage crisis was in its early stages, but the Committee opposed government efforts to assist defaulting borrowers, pointing out that lenders who extended risky mortgages with little or no borrower down payments and often with low "teaser" interest rates were then justifiably suffering the costs of their mistakes (245). In retrospect, this statement and another in September 2007 (249) misjudged the severity of the subprime delinquencies to come, but its cautions against government interventions to keep subprime lending going when the market itself was unwinding were on the mark. In addition, with the benefit of 20/20 hindsight, the Committee was late to criticize the securitization of subprime mortgages, which created opaque securities whose true worth investors and ratings agencies had difficulty discerning (especially as the financial crisis got underway).

As early as 2001, the Federal Reserve began exploring how to rein in those subprime mortgages that critics were characterizing as "predatory": mortgage loans that lenders tricked vulnerable borrowers into signing.

Nonetheless, earlier Shadow Committee statements opposing increased purchases by the housing GSEs of securities backed by subprime mortgages look prescient in light of what happened to Fannie and Freddie in the fall of 2008. (For further discussion of "what ifs" had Shadow Committee recommendations regarding subprime lending been followed, see Chapter 15.) Even as late as December 2007, less than a year before the financial crisis' peak, the Committee urged Congress to give the Office of Federal Housing Enterprise Oversight, the housing GSEs' regulator, SEIR or prompt corrective action authority to take them over and potentially close them down if their capital cushions fell too low. Eventually, Congress would give the Treasury authority to place Fannie and Freddie into receivership, which meant that they would be able to continue operating, although under federal control—which is precisely what happened in the fall of 2008.

By late 2007, the true severity of the housing foreclosure crisis was becoming evident. The Treasury Department had offered the first of what would be many plans for restructuring mortgages of delinquent borrowers, many of them, but not all, with subprime mortgages—which especially would become apparent as the economy tipped into a deep recession. Eventually, as many as one-quarter of all homeowners in the United States at one time would be underwater, meaning that the values of their homes fell below the values of their mortgages.

The Committee was critical of the initial Treasury homeowner assistance plan proposed in November 2007 for doing both too much and too little (250). The plan was too much in the sense that it was not clear, at least at that point, that the foreclosure problem was national in scope and that a collective-action problem impeded mortgage servicers from working out new payment arrangements with borrowers. I and other observers disagreed: too many parties were involved on both sides of subprime securities—investors and borrowers, with servicers in between—to count on the market alone solving this problem. At the same time, the Committee argued that the Treasury plan was too timid because it did not cover all borrowers in distress. Nonetheless, in May 2008, the Committee had kinder words to say about the five-year freezing of interest rates on "teaser rate" adjustable mortgages that the Treasury outlined in its November 2007 plan, although the Committee also noted that the plan did not cover those homeowners who were already delinquent on their loans or in foreclosure (259).

Looking back, the Shadow Committee initially was just as stumped as policymakers were about how to address what would clearly become a national housing foreclosure crisis, which the Committee did recognize had wider adverse macroeconomic consequences. One interesting idea the Committee floated in February 2008, but which policymakers never implemented, was for the federal government to encourage mortgage servicers to accept a deed in lieu of foreclosing on borrowers at risk of losing their homes and in return renting those homes back to the same residents (255). This would have reduced vacancies and the distress they caused to neighborhoods with otherwise-high foreclosure rates (255).

The Committee's statements also critiqued, late in the process to be sure, the securitization of subprime mortgages in particular, which sliced and diced different tranches of rights to income and repayment of principal into different securities, greatly complicating borrowers and investors' ability to work out with servicers, on a large scale, mortgage modifications that would have served the interests of all the stakeholders.

Ironically, at least in the Committee members' view, one of the mortgage-related regulations issued post-crisis by the new Consumer Financial Protection Bureau will weaken mortgage origination in the future (337, 344). This complex Qualified Mortgage (QM) rule is designed to prevent mortgage borrowers' losses by putting the burden on lenders in future foreclosure actions to prove that borrowers initially had sufficient resources to qualify for their mortgages. But if the loan is a QM, then lenders have certain defenses in foreclosure lawsuits, provided they can show they made reasonable and good-faith efforts at documenting borrowers' income and assets. One of the Shadow Committee's main concerns was that the QM exception would still allow too many low-quality loans to be originated and securitized, laying the groundwork for another housing bubble. So far, this outcome has not materialized, but the QM rule, at this writing, has been in place for only three years.

The Future of the GSEs and Federal Housing Policy

Securitization of mortgages backed by subprime mortgages has ground to a halt since the financial crisis; only mortgages meeting the underwriting standards of Fannie and Freddie—and to a more limited degree prime "jumbo" mortgages over the Fannie/Freddie ceiling amounts—have been securitized. Yet the future of these two housing GSEs is unclear because one glaring omission of GLB Act was its failure to address their future (282).

In February 2011, the Treasury Department issued a white paper aimed at addressing this omission by offering three options for the future of Fannie and Freddie. Notably, all the options presumed that both GSEs would be gradually wound down and privatized. The Committee promptly applauded the Treasury for advocating this bold approach (308), which the Committee had urged well before the 2008 crisis (262). Congress took no action on any of the Treasury's proposed options.

Going forward, four possible scenarios still remain, depending on the outcomes of the 2016 presidential and congressional elections:

1. Eventually, the Treasury will return the GSEs to private hands and cease taking their profits (perhaps being compelled to pay damages to the plaintiff shareholders if they prevail in their legal challenges). The organizations will then continue operating much as they did before the crisis, but very likely without increased housing affordability goals.

2. The two GSEs will be wound down, but the Federal Reserve will continue to be able to "rescue" the mortgage market in a crisis by buying mortgage securities.

3. The GSEs will be transformed into some other kind of entity, either with more limited powers than those they currently have or as new government backstop reinsurers of private mortgage insurers in the event of future catastrophic or systemic crises in the mortgage market.

4. The status quo will continue, as no consensus around any of the above three reform ideas (or something else) materializes.

In the latter three scenarios, the federal government would continue to play some role, directly or indirectly, in assisting the mortgage market and either explicitly or implicitly backstopping much of the mortgage market from a future meltdown.

Regarding housing policy more generally, many economists would argue today that in light of the financial crisis, the social benefits of home ownership (such as giving people greater stakes in their communities, reducing crime, and so forth) are at least balanced, if not more than offset, by the disincentives that locked-in homeowners have to remain where they are rather than moving to better jobs and careers when local economies turn down.

Eventually, as many as one-quarter of all homeowners in the United States at one time would be underwater.

Politically, however, it is unlikely that policymakers will eliminate all subsidies for home ownership, given that roughly two-thirds of Americans, and likely a higher percentage of all *voters*, receive some form of subsidy, whether through reductions in the interest rates they pay on their mortgage loans (by virtue of the GSEs' continued existence), the mortgage interest and residential property tax deductions for income tax purposes, or both.

Given this reality, many economists would sympathize with a conversion of the current home ownership tax deductions, which disproportionately benefit higher-income taxpayers (because the deduction is worth more to taxpayers in higher-income tax brackets) into a tax credit, with some ceiling. Alternatively, my guess is that many economists would also support some generalized percentage-of-income cap on all itemized deductions as a way of streamlining the tax code. Either idea might make it into any future comprehensive tax reform legislation.

As for housing programs for low-income households in particular, many if not most economists support explicit housing vouchers rather than less visible and less efficient tax subsidies for housing construction. Vouchers allow recipients to choose where to live rather than binding them to the specific units receiving construction subsidies. But in this era of budget austerity at all levels of government, it is difficult to be hopeful that voucher funding will grow at the pace of the overall economy.

Notes

1. The other two GSEs the Committee took note of are the Federal Agricultural Mortgage Corporation and the Student Loan Marketing Association (Sallie Mae).
2. In 2002, the Committee warned of the risks to taxpayers posed by Fannie Mae's widening "duration gap"—the mismatch in maturities between its assets and liabilities—which exposed the institution to a sizeable loss in its thin layer of capital if interest rates declined, as they later did (181).

XII. Insurance Issues

In 1991, when Congress was struggling with the all-too-apparent insolvency of the bank deposit insurance fund at the Federal Deposit Insurance Corporation, solvency problems also began to emerge in the insurance industry. These problems were not of the same magnitude as those in the banking sector, but they nonetheless added to the overall concern about the state of the US financial system at the time.

Then and through the years, the Shadow Committee occasionally wrestled with policy issues related principally to the safety and soundness of insurers, which were both similar to and different from those affecting banks. Like banks, insurers are funded by their customers. Like depositors, insurance policyholders are protected by state guaranty funds against the failure of their insurers (also up to some limits, which can vary by state and type of insurance). And like banks, insurers are regulated to ensure their solvency.

But there are some notable differences between banks and insurers. Bank depositors can withdraw their funds at a moment's notice, without penalty in the case of demand deposits and savings accounts, and typically with a small penalty for certificates of deposit. In contrast, insurance policyholders are paid back (and possibly paid more than they invested) only if they have valid claims arising from events they have insured against (for example, car accidents, various kinds of damage to their house, or loss of life). The exception is annuity contracts sold by life insurers that pay out on a contract basis, which are savings instruments analogous to bank accounts.

Another key difference involves regulation. Federal and state authorities handle bank regulation, while states alone have historically regulated insurance.

Shadow Statements

The first Shadow Committee statement about insurance was in May 1991, when the Committee expressed concern about reports of rising safety and soundness problems in the industry (71). In the absence of federal regulation, the Committee called on the National Association of Insurance Commissioners (NAIC), the organization representing all state insurance regulators, to standardize and make public a database containing financial information of regulated insurers. Such records would be analogous to the quarterly call reports that banks file with their regulators, rather than the annual NAIC reports, so that outside analysts could better judge regulators' financial health.

In December 1999, the Committee addressed another insurance issue raised by proposed congressional legislation: the creation of a federal backstop for property-casualty insurers and state-sponsored catastrophe plans for losses (above a specified threshold) due to natural catastrophes (e.g., earthquakes and hurricanes). This legislation would have extended the federal government's insurance role beyond crop and flood insurance. The Committee posed a series of questions it believed must be answered before such a backstop should be created—which Congress has not yet done. Among the most important questions was why insurers should not first be allowed to set aside tax-deductible reserves for catastrophes, which they still cannot do today.

After the terrorist attacks of September 11, 2001, Congress considered various proposals for a federal backstop for insurers providing coverage against large losses due to future terrorist acts. Three months later, the Committee endorsed the concept in principle, suggesting that any interruption to private terrorism insurance would be temporary, so that the backstop could be eventually phased out (172). In September

2002, the Committee noted that the private market for terrorism coverage had indeed already recovered significantly, suggesting higher thresholds are needed for any federal backstop (182). By May 2004, the Committee was calling on Congress to not renew the Terrorism Risk Insurance Act (TRIA) (207).

Although TRIA was extended by Congress in 2005, 2007, and 2015, the Committee's suggestions for a more limited federal terrorism reinsurance program with a cutback in coverage eventually were reflected in the revised act.

Contingent commissions, or commissions paid by insurers to brokers, a practice by which much insurance is sold, came under scrutiny in the mid-2000s by state authorities in New York and California. The Shadow Committee acknowledged that such commission arrangements can lead to a conflict of interest with brokers, but can also increase insurers' premium volume and thus the statistical reliability of their rates. If the net effects of contingent commissions were negative, the Committee argued that the solution lay in mandatory disclosure to policyholders of these arrangements (211). The NAIC endorsed a similar remedy.

One continuing, unresolved issue is whether insurance companies, like banks, should be able to choose between having a national (or federal) charter or being regulated by the states. In May 2001, the Shadow Committee weighed in on this matter in a nuanced fashion: it supported an optional chartering system that preempted state rate and form regulation, but it cautioned against expanding the federal safety net for insurance customers and companies, a move that would extend moral hazard to the insurance industry (170). By May 2006, the Committee endorsed a preemptive national charter option for insurance companies and securities firms (230). However, Congress has never adopted the optional charter idea, and at this writing, little political support for it seems to exist, beyond some large national insurers' desire for it.

Looking Ahead

Although an optional federal charter for insurance is not likely anytime soon, a significant portion of the insurance industry is now subject to some form of federal safety and soundness regulation under two parts of the Dodd-Frank Act, which is discussed more extensively in the next chapter.

First, Dodd-Frank gives the Federal Reserve oversight of thrift holding companies (THCs). Fourteen insurers are THCs because they own a single thrift. Second, the act created a new systemic risk overseer, the Financial Stability Oversight Council, which has designated three large insurers, AIG, Metropolitan Life, and Prudential, as systemically important financial institutions (SIFIs). The Federal Reserve regulates the safety and soundness of these insurers, in coordination with the states. Under these two Dodd-Frank provisions, the Fed now supervises and regulates potentially about one-third of the life insurance industry and one-quarter of the property and casualty insurance industry, when measured by premiums.[1] The reason those fractions are unclear is that MetLife successfully sued the Treasury on its SIFI designation of the company; at this writing, that federal district court decision is on appeal.

It is also unclear is how and to what extent the Fed will actually regulate the capital of SIFI and THC insurers. Specifically, will the Fed create an entirely new and different capital standard from the ones now used by the states? And under any capital standard, will it impose or encourage the states to adopt *and effectively enforce* a structured early intervention and resolution system for individual insurers, which would be consistent with the regulatory system that the Shadow Committee recommended for banks? One way or another, these questions are likely to be answered over the next few years.

Dodd-Frank also created a Federal Insurance Office (FIO) within the Treasury Department. The FIO plays a solely advisory role on domestic and international insurance issues. Likewise, the independent insurance expert votes on matters before the Financial System Oversight Council, but has been excluded from the team of US regulators representing the country before international insurance forums.

The FIO is naturally well-positioned to become a national insurance regulator, analogous to the Office of the Comptroller of the Currency, which is also technically housed within the Treasury, should Congress and the president ever agree to an optional system of federal chartering of insurance. However, it may take a crisis in the insurance industry, underscoring the failure of state regulators, for that to happen, and even then, it is not clear that a future Congress would see federal regulation as the answer to any such future problem.

Notes

1. Bipartisan Policy Center, *The Business of Insurance and Banking: Understanding Two Different Industries*, September 29, 2015, http://bipartisanpolicy.org/wp-content/uploads/2015/09/BPC-Banking-Insurance-Primer.pdf.

XIII. The Financial Crisis of 2008

There have been so many accounts of the financial crisis of 2008 and the legislation enacted in its wake, the Dodd-Frank Act of 2010, that my treatment of these subjects here will be relatively short and to the point.

As any reader of this book likely will know, the crisis was precipitated by the steep nationwide decline in housing prices in the mid-2000s, which led to soaring delinquencies in mortgages and the various securities on which they were based. The heart of the problem, however, was excessive mortgage lending to subprime and risky borrowers in particular—those who could not qualify for standard prime mortgages and who thus posed higher risks of nonpayments—coupled with excessive leverage by the depository institutions that they or their supposedly off-balance-sheet creations were allowed to maintain in the run-up to the crisis. With thin layers of capital available to absorb losses, too many depository institutions—especially large ones—were driven into insolvency when securities backed by subprime mortgages began to plunge in value or could not be traded at all. These securities also infected the nation's investment banks, which had underwritten them; the nation's largest insurance company (AIG) through the guarantees its now-infamous financial-products affiliate had provided; and the two housing government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. The fact that the largest commercial banks also relied heavily on large, uninsured deposits that could be withdrawn in an instant, while investment banks and money market mutual funds, both nonbanks, likewise had "runnable" liabilities, also fanned fears of a widespread financial panic during the height of the crisis, September 2008.[1]

Ultimately all of these troubled institutions but one (Lehman Brothers) were rescued in some manner by federal regulators out of fear that the damage caused to the uninsured creditors and counterparties of banks and nonbanks could bring down the entire US financial system. Even with these rescues, the financial systems and economies in the United States and other developed economies (Europe in particular) whose banks had also bought the toxic mortgage securities still were heavily damaged by the financial crisis that ensued in the fall of 2008 and into the following years.

Since the crisis, numerous academic papers and various personal memoirs of key decision makers at the time have been published, each providing an account of the events leading up the crisis, the decisions made during it, and the legislative and regulatory responses after it had eased. Some of these accounts put most or all of the blame on a single villain, while others identify many. The Dodd-Frank Reform Act of 2010 reflects the multiple-causes view of the crisis and attempts to fix them so that they cannot cause a future crisis, or one as severe. Dodd-Frank also created an official Financial Crisis Inquiry Commission to report on roughly 20 potential causes of the crisis. (Some critics noted the oddity of establishing a commission on causes only *after* the legislative fixes had already been adopted.)

The multiple issues raised by the financial crisis and the resulting legislation were both a blessing and a curse for the Shadow Committee. On the plus side, the Committee was given the opportunity to opine on multiple policy issues, many of them outside the Committee's initial core expertise relating to depository institutions, because the crisis did not affect or arise only from weak banks.

On the downside, however, the very breadth and complexity of Dodd-Frank, coupled with the many other voices expressing their views in the policy arena, ironically complicated the Committee's work. For example, the length and detail of post-Dodd-Frank regulatory proposals made it more difficult for the Committee to digest this complexity, pick out particular issues of broad enough interest to the public and policymakers, reach consensus, and then distill the findings in the concise format of Shadow statements. Likewise, with many more voices—from think tanks, lobbyists, and various interest groups—added to the financial policy table after the crisis, it became more difficult for Shadow statements to break through the din. Given the uncertainty of long-term funding for the Committee, a decision was made in mid-2015 to suspend its regular quarterly meetings after the December 2015 meeting.

I make no attempt in this chapter to address each and every policy issue raised by the 2008 crisis and its aftermath. Rather, I concentrate just on those questions the Committee decided to tackle, and I briefly describe the Committee's statements and their rationale. Readers wanting more detailed description and analysis on these and other crisis-related issues have plenty of material already in the public domain to consult.

Shadow Statements

Once the crisis began to unfold in 2008, the Committee issued an increasing number of statements about how to prevent such episodes in the future, some well before Dodd-Frank was enacted. Some of these statements are summarized in other chapters, especially Chapter 11, which deals with housing issues. Here I concentrate on the issues not addressed elsewhere.

Macro-Prudential Regulation. One issue on which there is consensus post-crisis is the need for policymakers to somehow take better account of macroeconomic risks to the financial system than they did pre-crisis, when bank regulators in particular were focused solely on the health of individual banks. The question is how.

In May 2009, the Committee endorsed what could be called the minimalist approach: having a single agency (possibly the Fed), a group of agencies, or a new agency monitor macro risks to the financial system, but not designating any institutions as systemically important, which would enshrine them with "too big to fail" (TBTF) status (271). Dodd-Frank used a more aggressive approach, adopting the first half of the Shadow Committee's suggestion—creating a new office within the Treasury Department to assume the monitoring function—but rejecting the second half by also creating a body of existing regulators, the Financial Stability Oversight Council (FSOC), whose principal responsibility is to make the institution-specific systemic risk designations that the Committee wanted to avoid. Dodd-Frank then gave the Fed authority to design toughened capital standards or supervisory intensity for these systemically important financial institutions (SIFIs) to offset the moral hazard of their implicit, if not explicit, TBTF status.

As for banks, the FSOC has no discretion: all those with assets of at least $50 billion are automatically deemed by Dodd-Frank to be systemically important. But the FSOC also was required to decide if any nonbanks fell into the same category, whether by virtue of their size or connectedness with other financial institutions. Since the law was enacted, the FSOC has made four nonbank designations: the nation's largest nonbank commercial lender, GE Capital; two life insurers, Prudential and Metropolitan Life; and a leading property/casualty and life insurer, AIG.

In January 2016, MetLife announced plans to spin off its personal lines life insurance unit that offers annuities, an action the company could use to ask the FSOC to reconsider its SIFI designation. The company promptly filed a lawsuit in federal district court contesting its original designation. In late March 2016, the court sided with MetLife, a decision which at this writing is on appeal. Until this decision was handed down, the FSOC also had signaled it could designate one or more large asset managers to be SIFIs, but it has not yet taken that step, one that the Shadow Committee has argued would not be justified because asset managers are not leveraged like banks, securities underwriters, or insurers (347).[2]

Money Market Funds. Among the many controversial rescues mounted by federal authorities during the financial crisis was a guarantee of money market mutual fund (MMMF) assets after the Lehman bankruptcy forced one money market fund, the Reserve Fund, to "break the buck" (paying less than the $1.00 per share value). Federal authorities were worried that a run on the Reserve Fund would spread quickly to other MMMFs and that without a federal guarantee on these assets, corporations selling short-term commercial paper would have a hard time rolling it over or selling new issues, because money market funds are large purchasers of these debt instruments. So the Treasury took the unprecedented step of guaranteeing all money market fund deposits, while the Federal Reserve opened a special lending facility to support the purchase of commercial paper.

Since the law was enacted, the FSOC has made four nonbank designations: the nation's largest nonbank commercial lender, GE Capital; two life insurers, Prudential and Metropolitan Life; and a leading property/casualty and life insurer, AIG.

The FSOC and SEC wrestled for several years following the crisis with how to prevent future money market fund runs without providing a federal guarantee. In September 2009, the Committee outlined two options: (1) requiring these funds to operate like other mutual funds and value their shares daily consistent with the market value of their underlying assets, thus having a so-called floating net asset value (NAV); or (2) constraining the riskiness of the assets in which MMMFs are permitted to invest (275).

The SEC initially proposed the latter option, coupled with a requirement that MMMFs run periodic stress tests to ensure that they can hold a stable $1.00 per share NAV. However, the Shadow Committee expressed several concerns about the specifics of this proposal: it unduly restricted the maturities of the funds' investments, which could hamper the market for commercial paper, and more importantly, the proposal relied mistakenly on credit ratings to guide the funds' purchasing decisions, an approach inconsistent with the Committee's view that regulators should be moving *away* from relying on credit ratings. Instead, the Committee recommended that the SEC adopt the floating NAV requirement for MMMFs sold to institutional investors (275, 309). In February 2012, the Committee broadened the scope of its floating NAV proposal to cover retail MMMFs as well, while also suggesting a new type of guaranteed MMMF that could promise investors a $1.00 per share NAV, provided the fund also met minimum capital and liquidity standards (325). In 2014, the SEC adopted a more limited plan focused solely on institutional prime MMMFs (those investing in corporate as well as government securities), requiring them to sell and redeem shares at a floating NAV.

Emergency Lending. In December 2009, following the Fed's emergency lending to specific institutions (AIG and J.P. Morgan in its acquisition of Bear Stearns) and its creation of various new broader-based lending facilities, the Committee addressed Representative Ron Paul's (R-TX) proposal to require the Government Accountability Office to "audit" the Fed for both its monetary policy actions and emergency lending activities, especially those invoking the "unusual and exigent circumstances" language of Section 13(3) of the Federal Reserve Act (279). The Committee was sympathetic with an assessment of the Fed's lending actions but had a different suggestion for monetary policy: rather than having yet another body review the Fed's monetary policy decisions, the Committee suggested less of a lag (than the then-current three weeks) in publishing the FOMC minutes, which would improve transparency of the Fed's decisions. Since the Committee's statement, the Fed has improved transparency by having the chairman conduct quarterly press conferences, and it has released more information about its emergency lending, while Congress has limited 13(3) lending for only broader-based purposes. (I discuss this specific action again in Chapter 16.)

In the same month, December 2009, the Committee addressed another issue raised by the Fed's extraordinary lending—specifically loans to the 19 designated primary dealers in federal securities (280). During the crisis, the Fed established a special credit facility just for these dealers to ensure continued operations in the important Treasury securities markets. The Committee noted, however, that the system of distributing federal securities through just these dealers located in New York was antiquated and urged that the distribution process be opened to a much larger number of institutions, a policy that the Committee again advocated in December 2014 (355).[3] In Europe, for example, the European Central Bank has more than 500 counterparties. In the United States, the number of primary dealers at one point hit a high of 46, but now stands at a much lower number, so these recommendations have yet to be fully taken to heart.

Nonbank Failure Resolution. In September 2008, what would turn out to be height of the crisis, the Committee urged that better ways be found for resolving failing investment banks—this after the failure of Lehman Brothers (263). This statement presaged the inclusion of Title II in Dodd-Frank, which vested new "orderly resolution" procedures in the Federal Deposit Insurance Corporation (FDIC), intended to avoid what many viewed to be a highly disorderly process of resolving large or highly interconnected failed financial firms in the future. This issue is front and center in the memoirs of three key actors during the crisis—Treasury Secretaries Henry Paulson and Tim Geithner and Fed Chairman Ben Bernanke—and it was a major challenge to the Congress in debating and ultimately enacting Dodd-Frank.

The Committee noted, however, that the system of distributing federal securities through just these dealers located in New York was antiquated and urged that the distribution process be opened to a much larger number of institutions.

The Shadow Committee weighed in on this issue seven months before Dodd-Frank was signed into law, supporting only those solutions that preserved market discipline (281). This translated into opposition to designating specific institutions as systemically important, supporting the normal bankruptcy process rather than a new administrative resolution process for resolving failed nonbank financial institutions, and exempting certain liabilities (such as repos) from bankruptcy procedures to prevent knock-on financial disruption (281). Dodd-Frank's Title II resolution process, which puts the FDIC at the helm of orderly resolutions of large, complex nonbanks and allows the Treasury to provide emergency lending to keep failed institutions operating while being wound down, is inconsistent with the first two of these principles.

I personally feel torn on this resolution issue. I strongly support market discipline, which is a main reason I sided with the Committee throughout my tenure with its insistence on a subordinated debt requirement (now modified as a requirement for convertible debt, as discussed in the next chapter). However, I am also strongly sympathetic with the need during a true systemic crisis—as the 2008 crisis certainly was—to prevent financial contagion, even if it requires temporary lending support to prevent short-term creditors, or those who can most easily run, from taking some loss (or a "haircut"). Title II in Dodd-Frank recognizes this latter need by allowing the FDIC to borrow from the Treasury to support the liquidity needs of a failing, large, complex nonbank, with an *ex post* assessment on a set of other large institutions if the Treasury were to suffer a loss.[4]

I am not convinced that the bankruptcy laws, even with their exemptions for short-term obligations and derivatives contracts, would be sufficient to prevent a contagious run in a future crisis, but I remain open-minded on the subject and may one day be convinced. At a minimum, bank regulators or their relevant inspector generals should be required to conduct and report on forensic examinations of the failures of all large complex financial institutions, as was done on an ad hoc basis by the bankruptcy court handling Lehman Brothers (288). The Shadow Committee also suggested an independent expert assessment of the Fed's emergency lending programs during the crisis (or any future crisis), while applauding the Fed's *ex post* publication of information about those programs (301).

Executive Compensation. Another issue that surfaced after the federal government extended its safety net—the Treasury through the Troubled Asset Relief Program and the Fed through its emergency lending—concerned the degree to which the government should also regulate the compensation of executives in firms that benefited from this assistance. The Shadow Committee noted in a statement issued in December 2009 that normally the federal government should not become involved in compensation, for that matter is best left to private decision making (283). But policymakers in the United States and other countries made an exception for the *form* of compensation—what portion is cash and what is deferred, depending on the futures of the company—for institutions that benefited from government intervention.

The Committee recognized that this kind of intervention was "appropriate" but warned of unintended consequences, pointing to the $1 million limit Congress imposed on executive pay in 1993, which boomeranged when companies began awarding large stock option packages to their executives, increasing incentives to take short-term risks that in some cases led to the firms' demise. The Committee concluded its December 2009 statement with an observation that remains just as true today: "the proper mix of current and deferred compensation is not easy to determine."[5]

Higher Capital Requirements. Perhaps the clearest and most obvious post-crisis financial reform was to lift bank capital standards, thereby increasing individual banks' cushion against loss and in the process improving the banking system's resilience to future shocks. Dodd-Frank directed the banking regulatory agencies to increase capital standards, and even before that act, US banking regulators were working with their counterparts in the G20 countries to do that in as coordinated a fashion as possible.

In September 2010, the G20 and national bank regulators agreed to raise capital standards for all banks and to add a small countercyclical buffer in good times, as well as a 3 percent of asset leverage ratio apart from the higher risk-based standards. In the same month, the Shadow Committee applauded this effort but repeated its long-standing critiques of using the Basel risk-based formula to measure capital (295). The Committee also argued that the proposed leverage ratio was too low and that the 10-year phase-in of the new capital requirements was too long.

In a February 2011 statement, the Committee questioned whether any discretionary countercyclical capital requirement actually would be imposed in "good times" when it was most needed (307). Four years later, the Committee called for a substantially higher optional leverage ratio (10–15 percent of assets and off-balance-sheet exposures) for globally systemically important banks (G-SIFIs) in lieu of a proposed additional risk-based capital charge for such institutions (357). That has not happened, but in December 2015, the Federal Reserve did propose a countercyclical capital standard for the largest banks, those with assets equal to or larger than $250 billion.

Liquidity Standards. After the crisis, the Basel Committee proposed a new liquidity rule designed to assure that banks could better withstand sudden increases in demands for withdrawals. In September 2011, the Shadow Committee expressed concern about the proposal's complexity and suggested instead a simple minimum cash-to-asset ratio of 15–20 percent, analogous to a simple minimum leverage ratio of capital to assets, including some adjustment for off-balance-sheet liabilities (317). For this purpose, only vault cash (currency) and bank deposits held at the central bank would count as liquid assets.

The following year, in December 2012, the Shadow Committee criticized the Basel liquidity proposal for permitting broader noncash assets—securities of various types—to count toward the liquidity requirement, but with various haircuts (332). The Committee argued that these haircuts lacked any empirical basis and urged the narrower definition of liquidity it had previously suggested.

In January 2013, the Basel Committee issued its final liquidity rule, essentially sticking to the framework outlined in the initial (complicated) Basel liquidity proposal, an approach that was directly contrary to what the Shadow Committee had suggested. It was yet another example of how the Basel Committee opted for a more complex regulatory approach rather than one that was simpler and, in the Shadow Committee's view, easier to enforce and comply with (343, 346).

Risk Retention. In principle, one of Dodd-Frank's more defensible reforms is its risk-retention provision: the requirement that those who securitize financial instruments have "skin in the game," specifically that they retain at least a 5 percent risk of loss.

In May 2011, the Shadow Committee questioned whether this seemingly good idea in theory would achieve its noble objectives in practice because the act exempts mortgages guaranteed by the Federal Housing Administration, Fannie, and Freddie, as well as securities backed by qualified residential mortgages, or those in which borrowers have made down payments of at least 20 percent (311). Because many homeowners cannot come up with that 20 percent, there would be political pressure, the Committee predicted, to channel many mortgages through Fannie and Freddie, which, as noted, are exempt from the risk-retention requirements.

The Committee concluded its December 2009 statement with an observation that remains just as true today: "the proper mix of current and deferred compensation is not easy to determine."

The Volcker Rule. At the Obama administration's urging, one of the last items that made it into Dodd-Frank was the Volcker Rule, named after Fed Chairman Paul Volcker. Although simple in concept—a ban on proprietary trading by banks—the Volcker Rule has proved devilishly difficult to write and implement.

The Shadow Committee early on highlighted these problems, pointing to the difficulty of regulators and banks in distinguishing permissible hedging and market-making trades from proprietary trades (306). The Committee also argued that the rule would be easier to enforce if all securities trading activities by banks were conducted out of a separately capitalized subsidiary (326, 350). The line-drawing difficulties, I predict, will continue to plague the administration of the Volcker Rule, which in any case, addresses an issue, proprietary trading of securities by banks, that was not even a minor cause of the 2008 financial crisis.

Federal Reserve Responsibilities. Finally, shortly after Dodd-Frank was enacted, the Committee addressed the Fed's large new responsibilities under Dodd-Frank: membership in the FSOC and the safety and soundness oversight responsibilities for all SIFIs, including nonbanking institutions with which the Fed previously had no supervisory experience. In particular, in a September 2010 statement, the Committee expressed concern that the Fed lacked the staff and experience to handle these new responsibilities, and accordingly, predicted it would rely on restrictive new rules that would impinge on future economic growth (298).

In the five-plus years since that statement was issued, the Fed, including the district Federal Reserve Banks, has significantly increased its hiring of nonbank specialists, especially those knowledgeable in insurance regulation, given the SIFI designation of certain large insurers. While legitimate arguments exist against such designations—and as noted earlier, MetLife's designation has temporarily been overturned by a federal district court—the limited number of SIFI designations makes it difficult to argue that, at least in this function, the Fed has yet acted in a way that seriously hurts economic growth. Whether this conclusion will continue to be true is difficult to predict.

A Post-Crisis Financial Reform Agenda for the Future

From the outset, Dodd-Frank has been highly controversial along partisan lines. By and large, Republicans have urged for a rollback of the law, while Democrats and the president have resisted any changes. This stalemate could change after the 2016 elections.

Several aspects of the law have been especially controversial, and I highlight my personal views on only a few here. I provide some additional thoughts for a future financial policy agenda in Chapter 16. Shortly after Dodd-Frank's passage, the Shadow Committee also provided a list of missed opportunities in the bill (296), including a winding down of the housing GSEs, a close examination of the new Consumer Financial Protection Bureau's activities, and greater penalties for excessively optimistic ratings by ratings organizations (304).

First, on the FSOC's role and its designation of banks and nonbanks as SIFIs: the $50 billion asset threshold for banks seems far too low, and a figure in the $250 billion range, indexed with some measure of inflation, seems more appropriate. I would not be surprised that Congress will agree, if and when it revises Dodd-Frank.

Second, there is still some discomfort with the "you know it when you see it" character of determining nonbank SIFI designations. Take the question of whether the failure of any nonbank could trigger a contagious run of liabilities analogous to bank deposits. No one can really know the answer to that question in advance. Until its SIFI designation was removed in June 2016, only GE Capital, which relies heavily on short-term commercial paper to finance its activities, should raise this type of concern. But that concern is gone now that GE has downsized its activities and persuaded the Fed to drop SIFI status for the firm. The largest life insurers present more ambiguous cases: while their traditional life policies are essentially "run proof," their annuities and guaranteed investment contracts are not, although they have slower fuses than deposits because of their withdrawal restrictions. How and whether Congress will need to address the distinction between large banks and large insurers is likely to depend heavily on the ultimate outcome of the MetLife litigation.

Third, there will be continued efforts to nick away at the TBTF problem. One of those may entail an effort to replace Title II's failure resolution process with a new bankruptcy-type regime administered by the courts. As I have noted, I remain open to such an idea, provided the federal government retains the ability to prevent runs by short-term creditors on *other institutions* that investors may reasonably deem to be similar to the failing firms in a crisis.

The Shadow Committee took the position in December 2010 that while it is important to keep the systemically important parts of large, complex financial firms operating during resolution, the receiver should impose at least some haircuts on short-term creditors. Otherwise, these large, complex firms will have undue incentives to rely on short-term funding (300). These two positions expose the inherent problems in crafting rules that may discourage excessive short-term funding for particular institutions in good times, but which may not work well during a full-fledged systemic crisis such as one the US experienced in 2008—when investors were ready to run, if they were able, from any institution that looked like those in trouble. Perhaps the only second-best solution is a regulatory one that requires financial firms of all types to meet *simple* minimum liquidity standards designed for a reasonable worst-case scenario. But even these standards cannot anticipate a truly worst case, nor is it necessarily desirable for them to do so.

An alternative regulatory approach is to require that financial firms be funded by instruments that automatically convert to equity as the firms' financial fortunes deteriorate—an idea discussed in more detail in Chapter 16. If investors and counterparties know that even a troubled institution can, in effect, be rescued automatically by its creditors, then short-term creditors may not be so eager to withdraw their funding.

In sum, a well-designed system of capital standards supplemented by minimum liquidity standards for all financial firms may be the best, politically achievable protection against the dangers of treating large, complex institutions as TBTF and protecting against financial contagion—even better than the best bankruptcy process for resolving failed large, complex financial institutions in lieu of the current administrative resolution process under Title II of Dodd-Frank.[6]

Notes

1. The importance of runnable bank and nonbank liabilities in greatly aggravating the crisis is a central theme in the books authored by Morgan Ricks and Hal Scott identified earlier in this book, as well in the book-length memoirs of several of the key federal decision makers during the crisis.

2. The Committee acknowledged in its statement (347) the dangers of mispricing bond funds, but argued that this was a regulatory concern of its own and that subjecting asset managers to prudential standards would not affect the risks to investors from mispricing.

3. The Committee also urged in its December 2014 statement that the responsibility for implementing open market operations be rotated among the Federal Reserve banks, not just lodged in New York, and that the president of the Federal Reserve Bank of New York be removed as a permanent member of the Federal Open Market Committee. The Committee suggested that both measures, by reducing the importance of the Federal Reserve Bank of New York in the Fed system, would also reduce the perceived undue influence of Wall Street financial institutions on the Federal Reserve System.

4. Even the Shadow Committee, which otherwise preferred bankruptcy for resolution of all nonbank financial firms, recognized that there might be unusual circumstances when public funds may be required to preserve financial stability. In such situations, it supported such intervention, as long as the details are made transparent (286). This position is not that far from the structure of Treasury borrowing that Dodd-Frank put in place in Title II, although Dodd-Frank uses an administrative procedure for resolution in such cases rather than the normal bankruptcy process.

5 In September 2015, the Committee addressed another compensation-related issue: an SEC proposal implementing a Dodd-Frank mandate that listing exchanges (such as the NYSE and NASDAQ) require executives at firms whose earnings have been restated to claw back excess incentive-based compensation linked to the misstated accounting measures. This requirement would be imposed on a "no fault" basis, and mainly for that reason, the Committee objected to it, since it would punish executives for actions for which they

had no responsibility (359). Moreover, precisely because of this, executive compensation may go up *ex ante* to account for this, an unintended but counterproductive outcome of the proposal.

6. In his book, *The Money Problem*, Ricks argues for more sweeping reforms, specifically extending deposit insurance to currently large, uninsured bank accounts and prohibiting near monies, or short-term runnable debt, issued outside the banking system, including money market funds, and repos for investment banks, among other instruments. While the theoretical case for this ambitious reform agenda is strong, I do not believe that it is politically viable any time soon.

XIV. International Financial Issues

Financial systems have become increasingly integrated across national boundaries, a trend that has produced several policy issues on which the US Shadow Committee chose to comment.

Interestingly and perhaps not surprisingly, other countries had to wrestle with similar policy challenges, especially during and after the financial crisis. Thus, it may not surprise readers to learn that finance scholars and experts in other countries eventually discovered the US Shadow Committee and wanted to replicate it elsewhere.

In 1999, the first Shadow Financial Regulatory Committee outside the United States was formed in Europe. This was followed by Shadow Committees in Japan, South America, New Zealand/Australia (Oceania), and Southeast Asia.

During their early years, the various non-US Shadow Committees consulted and corresponded with the US Committee, and many of their statements reflected similar views to those of the US Committee, although tailored to their individual countries or regions. Beginning in 1999, the US and non-US Shadows began to meet biannually to discuss common challenges and issue joint statements. In 2012, the Committees issued an entire book containing the individual Shadows' perspectives on the 2008 financial crisis and policy responses to it throughout the world.[1]

This chapter summarizes the US Committee's statements on matters of international finance and then describes the non-US Committee statements. Readers will find that the financial policy questions with which the US and non-US Committees wrestle are not all that different.

US Shadow Statements on International Financial Policy Issues

The US Shadow Committee's first statement on matters of international finance dealt with the Mexican financial crisis of 1994, which the Committee analogized to a bank run—or, in Mexico's case, a run from its dollar-denominated debt (117). The Committee acknowledged that the case for a worldwide bailout, led by the United States, was persuasive, given the spillovers between Mexico's economy and the US economy, coupled with the migration issues at the two countries' border. Nonetheless, the Committee expressed concern about the moral-hazard dangers of guaranteeing existing Mexican debt, and therefore it supported guarantees only of any *new* debt that Mexico had to issue to keep its economy intact, while compelling the restructuring of old debt by extending its maturity and lowering interest rates.

The notion that guarantees should be provided only "at the margin" could have been applied in later country-specific financial crises, such as in Cyprus and Greece. In fact, US bank regulators did adopt the idea in October 2008, when the Federal Deposit Insurance Corporation (after consultation with the Fed and the Treasury) guaranteed only new, but not preexisting, senior debt issued by banks.

The Shadow Committee weighed in again on international financial issues after the Asian financial crisis of 1997 (145). Without taking a position on whether and to what extent the resources of the International Monetary Fund (IMF)—the international lending agency that supports countries in crisis—should be augmented, the Committee urged that borrower countries in the future enact legislation to automatically haircut foreign creditors lending in foreign currencies if they do not roll over their loans. This step, the Committee argued, would reduce the moral hazard created by the prospect of continuing and future IMF bailout lending.

Toward the same end, the Committee urged countries to disclose accurately and in a more timely fashion the amounts of their foreign currency reserves and off-balance-sheet obligations. And to encourage domestic banks and their regulators to improve their performance, the Committee urged that countries open up their markets to competition from foreign banks. In retrospect, only the second of these suggestions—more disclosure—has come close to being adopted.

The Committee pointed to the Cyprus situation as demonstrating the dangers of a country offering to protect depositors but then allowing its banking system to grow very large relative to its GDP.

In September 1998, shortly after the implosion and Fed-orchestrated bailout of Long-Term Capital Management LP (LTCM), the Committee weighed in with several principles for the IMF and other countries to prevent future international financial crises: (1) deal expeditiously with insolvent financial institutions, ideally through SEIR; (2) ensure market discipline by requiring large banks to back a certain percentage of their assets with uninsured subordinated debt; and (3) maintain the free flow of capital across borders, except for limits on short-term debt denominated in foreign currencies (148). As for the IMF, the Committee again urged no additional funding unless borrowing countries implemented some form of the automatic haircut for foreign currency creditors of banks, as outlined above, and unless they did a better job of disclosing their foreign borrowings.

Except for lip-service commitments to early resolution of failing financial institutions and the Basel Committee's support for the voluntary use of subordinated debt, none of the Shadow recommendations have been adopted, although in 2015, the Basel Committee did support the mandatory use of convertible debt by banks. Indeed, several months after the Committee outlined its guidelines for future IMF lending, the IMF moved in the opposite direction by launching a program of preapproved "precautionary" lines of credit for countries—with its first application in a $41 billion credit line for Brazil—that could find themselves subject to liquidity problems. The Committee worried that the credit line and its availability for Brazil in particular would create an undue moral-hazard problem (152).

As for LTCM itself, the Committee supported the Fed being a facilitator to a creditor-led reorganization of the enterprise, but it was staunchly opposed, as were many other commentators and experts, to the Fed offering either an explicit or implicit subsidy to save the LTCM creditors or investors (151).

More than a decade later, various southern European countries found themselves facing financial crises. While the Shadow Committee largely avoided commentary on these matters, it did highlight in May 2013 some lessons from the bank-related crisis in Cyprus, which culminated in a European bailout, haircuts on bank deposit accounts exceeding 100,000 euros, and an *ex post* bail-in of uninsured deposits that were converted into equity in the nation's largest bank (338). The Committee pointed to the Cyprus situation as demonstrating the dangers of a country offering to protect depositors but then allowing its banking system to grow very large relative to its GDP.

An additional lesson, the Committee noted, was that bail-in systems should be defined in detail *ex ante*, not hurriedly once a crisis is underway. Chapter 16 highlights how a contingent capital system is an example of such an *ex ante* bail-in mechanism.

The US Shadow Committee also dealt with some non-crisis-related international financial regulatory issues. One involved an EU proposal, later adopted, on the safety and soundness regulation of financial conglomerates headquartered outside Europe but operating in Europe: they would have to either show that their home country systems of prudential regulation were equivalent to Europe's or establish a European holding company, subject to EU (and European national government) regulation. The Committee urged the EU to be flexible in its interpretation of regulatory equivalence, foreshadowing the EU's later decision that Securities and Exchange Commission (SEC) oversight would satisfy that test for US-based financial conglomerates (191). Somewhat ironically, however, despite the EU's recognition of the value of SEC prudential regulation of investment banks, the SEC essentially did nothing to prevent Bear Stearns or Lehman Brothers from taking excessive asset-side risks while funding these investments largely with short-term repos that proved to be unreliable in the 2008 financial crisis.

In February 2004, the Committee urged the federal financial agencies to continue and even broaden their dialogue with their EU counterparts, with a view toward reducing impediments to a true transatlantic market in financial services (203). That objective remains an ideal today, although one more difficult to achieve in the wake of the 2008 crisis, which many outside the United States (quite rightly) blame on inappropriate US policies for triggering, although inadequate bank supervision in the EU did not insulate banks and financial markets in that part of the world from US-initiated problems as well as they might have.

On the two sides of the Atlantic, opinions differed on which body of accounting standards should apply to public companies' financial reporting: US Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). In the mid-2000s, US securities authorities were insisting that all publicly traded companies use GAAP, while their EU counterparts were insisting on IFRS, unless the Committee of European Securities Regulators determined by June 2005 that US GAAP were equivalent to IFRS.

In 2004, the Shadow Committee urged a mutual-recognition approach to the impending impasse because it was unclear which set of standards was demonstrably superior. In the Committee's view, EU's regulatory authorities should permit US companies listing shares in the EU to continue using GAAP, while the SEC should allow EU-based companies trading on US exchanges to use IFRS (209). In 2007, this position was reflected in a joint EU-US statement essentially adopting the mutual-recognition approach (246).

In May 2009, however, the SEC issued a statement indicating a desire to have the US ultimately transition public company reporting away from US GAAP and toward IFRS by 2014. The Shadow Committee nonetheless continued its support for an optional approach, with companies on each side of Atlantic deciding which set of standards to use. The Shadow Committee expressed some optimism that the two standards might ultimately converge (273).

By April 2010, the Committee was calling for another option: companies wanting to be subject to the same set of global enforcement and reporting systems, presumably those operating and seeking to raise funds in many different countries, could opt into Global Segment (GS) reporting. In addition, through private contracting, companies could choose which jurisdiction would govern for their legal disputes (290). GS reporting and enforcement would have to be administered by a global or supranational body to assure cross-national consistency. Possible candidates for this job included the International Accounting Standards Board, the International Organization of Securities Commissions, or an entirely new body. These Shadow Committee recommendations have not been adopted.

Joint Shadow Committee Shadow Statements

Once other national and regional Shadow Committees were formed, efforts were quickly made to hold regular joint meetings of all the Committees, with the ultimate objective being to issue a joint statement thereafter.

The joint Shadow Committees were effectively arguing that Japanese authorities lance the boils in their banking system, experience any short-term pain, but then move on to a permanently safer system going forward.

The first such meeting was held in June 1999 by the European, Japanese, and US Committees. Its statement critiqued the 1999 Basel capital standards proposal for relying on credit ratings to determine asset risk weights and for allowing some banks to use their own internal models to determine their required capital. The statement (I1) urged the Basel Committee instead to measure capital using market values of assets and liabilities and to require banks to submit to the discipline of the debt market by issuing subordinated (uninsured) long-term debt. Another joint statement, this time including the newly formed Latin American Shadow Committee, repeated these critiques (I3). Readers will recognize, of course, that the joint Shadow Committee criticisms and recommendations echoed similar sentiments expressed earlier (and later) by the US Shadow Committee.

In October 2000, the same three Shadow Committees addressed reform of bank capital standards and their enforcement, specifically in Japan (I2). As readers of this book well know, Japan has been mired in more than two decades of slow growth since its real estate and stock price bubbles popped in 1989. Problems in the banking system have plagued the Japanese economy throughout this period. In outlining the same recommendations for sound banking that the US Committee had long recommended for the United States—bank capital standards, ideally measured using market values for bank assets, enforced by prompt corrective action, and supplemented with market discipline provided by mandatory subordinated debt—the joint Shadow Committees were effectively arguing that Japanese authorities lance the boils in their banking system, experience any short-term pain, but then move on to a permanently safer system going forward.

This was not the course Japanese authorities took. In this they were not alone: European banking regulators did not adopt these measures either, and US banking regulators, as discussed throughout this book, adhered to prompt corrective action (or SEIR) for only about 15 years following the enactment of the Federal Deposit Insurance Corporation Improvement Act through the mid-2000s but then abandoned the approach in the run-up to the 2008 financial crisis.

In October 2002, the expanded group of four Shadow Committees turned to a different problem affecting the international financial system: the inability of many sovereign governments to repay their debts. This was a familiar problem from the 1980s, but with a new twist: many of those loans were jointly extended by multiple banks and other creditors (I3). This raised the inevitable problem of holdouts. A small minority of debt holders could block any renegotiated loans, which increased the need for IMF borrowing to sustain governments unable to complete their renegotiations.

The joint Shadow Committee statement endorsed the IMF's urging that future borrowing arrangements contain collective-action clauses (CACs), which permit majorities of creditors to bind others in renegotiation deals. The Committee pointed to CACs then in use in some lending arrangements as models. It urged that existing debt be swapped for new debt containing CACs. However, the joint Committee faulted the IMF for failing to encourage parties to such borrowing arrangements to delay debt renegotiations in the hope that IMF lending would make such renegotiations unnecessary. My personal view in re-reading this particular statement is that it did not provide sufficient detail about precisely how the IMF would go about this.

By the 2004 Joint Shadow Committee, a fifth Committee had been formed, one for the Asian region. The 2004 statement emphasized the benefits of international financial integration—enhanced economic growth and macroeconomic stability, coupled with poverty reduction—and urged countries to accelerate it (I5). Toward this end, the Committee urged national governments to reduce barriers to foreign firms; accept either IFRS or GAAP for financial reporting, given that the differences between the two systems were relatively minor; and be careful about applying national rules outside a country's borders (extraterritoriality).

Given the financial crisis that followed four years later and the transmission of problems in US mortgage securities to other developed economies, does the case for enhanced international financial integration hold up? Broadly, I believe it does, and I believe that members of Shadow Committees worldwide would agree. But with the benefit of hindsight and experience, it should be clear that closer cross-border integration does not necessarily enhance macroeconomic stability: the closer the financial linkages between countries, the more quickly adverse shocks in one country can be transmitted to others, especially if they emanate from a large economy such as the United States or China.

This does not mean that further integration—which improves the allocation of investment to its most productive uses, wherever they may be around the world—should be slowed or reversed. But it does mean that in a world of enhanced financial integration, a greater burden is placed on national governments to ensure that their financial systems are sound and resilient. The Shadow Committees have agreed that the means for ensuring this outcome, especially in the banking sector, is through a combination of effectively enforced capital standards and the market discipline provided by creditors who cannot "run," namely holders of subordinated debt (or more recently, its improved variation, contingent capital or convertible debt).

In a world of enhanced financial integration, a greater burden is placed on national governments to ensure that their financial systems are sound and resilient.

In 2005, the joint Shadow Committee addressed a different financial problem, growing out of aging populations worldwide: the underfunding of defined benefit (DB) national pension plans (I6). With falling ratios of workers to retirees, these pay-as-you-go DB plans ultimately are unsustainable, given current benefits. Pension plans must move to defined contribution (DC) plans, with specific account balances owned by the individuals who contribute to them and ideally invested in a broad range of both domestic and international assets.

Looking back, one important omission from this statement was a discussion of how countries with a long history of pay-as-you-go DB plans, such as the United States, could and should transition to a DC system. In the United States, President George W. Bush proposed in 2005 moving gradually from a DB to DC system for Social Security but was unable to persuade Congress to adopt it, and no real effort has been made since to move in this direction.

By the September 2007 meeting of the joint Shadow Committees, a sixth committee from New Zealand (later broadened to include Australia and renamed "Oceania") had joined the group, and the US was in the early stages of what would become a full-fledged financial crisis. Nonetheless, the joint statement issued at that time identified several key factors that contributed to the turmoil then and later the full crisis: the opacity of the ostensibly off-balance-sheet structured investment vehicles sponsored by banks, mistakes by credit rating organizations in rating mortgage securities, and the unwarranted reliance on credit ratings in the bank capital standards formulated by the Basel Committee (I7).

The 2011 meeting led to a much more extensive joint statement the following year: an entire book on the financial crisis, how it started in the US and then spread to most other financial markets in the world (Latin America and Oceania being key exceptions), the underlying causes, and policy recommendations going forward. I will not describe the contents of the full book here, but for readers wanting a broader international perspective on the crisis, *World in Crisis* is available for free online.[2]

In October 2013, the six international Shadow Committees held their last joint meeting, at which they critiqued the Basel Committee's proposed liquidity coverage ratio for its excessive complexity (I10). In addition, the joint statement argued that the focus on liquidity masked the underlying solvency problems in the bank and nonbank financial sectors, which were the true reasons why the subprime mortgage crisis ballooned into a much broader financial crisis, not only in the United States but also in Europe.

The Future

Although the activities of the US Shadow Committee have been suspended, the members of the US Committee hope that the Committees outside the US will continue their valuable work. Given the continuing evolution of financial sectors globally and the seemingly continuous flow of new problems and challenges they present, there is certainly much for these Committees to do.

Notes

1. Joint Shadow Financial Regulatory Committee, *The World in Crisis: Insights from Six Shadow Committees*, November 19, 2012, http://www.luc.edu/media/lucedu/quinlan-graduate/pdfs/Joint%20Statement%20No.%207--Washington,%20D.C.--November%202011.pdf.
2. Ibid.

XV. A Counterfactual Financial History

The Shadow Financial Regulatory Committee's nearly 30-year history coincides with a remarkable and important period in US economic history, thus providing an occasion to look back at the key events that happened during this period through the very special market-oriented lens that characterized the Shadow's work. We cannot rerun history, of course, but it is an interesting thought experiment to imagine a counterfactual in which, broadly, the Shadow Committee's major recommendations had been policy throughout this 30-year timespan. Would the economy and financial markets have been as volatile, and economically costly, as they turned out to be?

In this chapter, I make the case for answering "no," based on my interpretation of the Shadow Committee statements reviewed in previous chapters. I stress that this account represents my own views, although I believe that many (if not all) Shadow members share these views, despite any differences we may have had on specific policy issues over the years.

Before I launch into the details, I offer this broad observation. This counterfactual reaches back several decades and thus imagines a sequence of historical events that would have been very different from those that actually unfolded: in other words, an economic system that would not have so heavily subsidized home ownership through less-than-transparent means, coupled with a continuously enforced system of structured early intervention and resolution (SEIR) that would have applied consistently to depository institutions and ideally to investment banks and the housing government-sponsored enterprises (GSEs) as well.

This is a very different sort of perspective than the typical short-run counterfactual exercises that government officials have asked themselves in their retrospective accounts of their time in government. For example, in reading through the memoirs of some of the key decision makers during the 2008 financial crisis, one is struck by the short-run nature of the questions these actors posed as they recount what happened: given the financial conditions that occurred on particular days or weeks, what would have happened if government had not come to the rescue of this particular institution at precisely those times? This type of question necessarily ignores the one or two decades of preceding history that would have brought events to the point at which these actors had very limited options (none of them good).

Fortunately, I have more freedom here than these decision makers had to ask and attempt to address some more fundamental, longer-term issues in constructing this counterfactual narrative. I hope that readers find this exercise nonetheless to be constructive—if for no other reason than it helps educate policymakers now and in the future to consider the longer-run consequences of their decisions.

Rerunning History of Savings and Loans

I begin with the easiest part of this counterfactual: would the demise of the thrift industry have occurred as deeply if an earlier resolution of failed and failing savings and loans had taken place, which the Committee advocated from the outset? I will not dwell on this for long, since it is well established that the magnitude of the crisis grew from 1986, when the Committee first began urging a swift resolution of the problem, until 1989 when President George H. W. Bush and Congress authorized a plan for closing insolvent thrifts and disposing of their assets through the Resolution Trust Corporation (RTC).

Had this step been taken much earlier, the Committee estimated the cost would have been much lower: only $15 billion in 1985, less than $30 billion in 1987, and $50–60 billion in mid-1988 (34). Instead, by waiting, the tab ran well over $100 billion in 1989 dollars, or roughly $200 billion in today's dollars. Compared to the cost of the 2008–09 financial crisis, this looks like a small sum, but it is not insignificant—$100–200 billion or more is still real money—and the lesson of tackling an obvious problem sooner rather than later is one that applies in multiple spheres of life, not just in public policy. Furthermore, had the RTC moved more quickly to sell failed thrifts to acquirers without taking back so many assets that it later had to dispose of, the ultimate taxpayer cost of the thrift resolution process conceivably would have been lower.

By shunting aside SEIR, regulators almost certainly magnified the costs of the crisis.

The Committee wrestled through the years with ways to stiffen policymakers' backbones in times when forbearance is the easiest way out. In 1990, for example, it recommended that Congress require regulatory agencies engaging in forbearance to provide estimates to the public of the costs of doing so (54), as a way of deterring such regulatory behavior in the first place. It is hard to know whether this idea, if implemented, would have made any difference in the 2000s.

An Effectively Enforced SEIR Regime

The savings and loan discussion brings me to the second part of the counterfactual: the effective enforcement of SEIR, a concept the Shadow Committee tirelessly championed and that clearly was its major contribution to financial regulatory policy. For a good period of time in the 1990s and early 2000s, this part of the counterfactual actually was in place.

SEIR was followed from its inception in 1991 to the mid-2000s, until bank regulators stuck too tenaciously to inflated book values while permitting certain of the nation's largest banks to create ostensibly off-balance-sheet structured investment vehicles (SIVs) to finance the issuance of mortgage-backed securities—and their variation, collateralized debt obligations (CDOs)—backed by subprime mortgages. Regulators mistakenly accepted their lawyers' conclusion that these vehicles were bankruptcy remote and hence posed no risks to the sponsoring entities. SIVs turned out to a massive end-run around bank capital standards, and thus the strictures of SEIR.

Failure to enforce capital standards, which in effect meant abandoning SEIR, meant that commercial banks were much more vulnerable to the downturn in home prices and the mortgage market when it hit with full force in 2007 and later. In essence, by shunting aside SEIR, regulators almost certainly magnified the costs of the crisis.

Likewise, large banks in particular were weaker throughout this period than would have been the case had policymakers listened to the Shadow Committee's consistent urgings that capital standards consist solely of a simple leverage ratio coupled with a mandatory subordinated debt requirement in lieu of the looser and misleading risk-based Basel capital standards that had been in place. If instead the large banks had had a much larger capital cushion and strong incentives to maintain it, then interbank lending might not have frozen in September 2008 when the financial crisis was its peak.

Before the crisis, the Shadow Committee did not address the application of SEIR, or something analogous to it, to investment banks, especially their holding companies. As it turned out, one of the larger investment banks, Bear Stearns, was rescued by a forced merger with J.P. Morgan with Fed assistance, while another, Lehman Brothers, actually failed. Shortly thereafter, the other two leading investment banks, Goldman Sachs and Morgan Stanley, experienced the equivalent of a deposit run when their repo lenders—institutional investors that loaned the banks funds secured by Treasury notes as collateral—would not roll over these instruments. Both investment banks promptly asked the Federal Reserve for permission to convert to bank holding company (BHC) status, using the Fed oversight this entailed as a signal of strength to investors (which worked). It is conceivable that if any or all of these investment banks had been required to maintain higher capital ratios and had been subject to an SEIR enforcement regime by their prudential regulator, the Securities and Exchange Commission (SEC), none of these institutions would have failed or had to turn to BHC status.

In his book about his life and the financial crisis, Fed Chairman Ben Bernanke argues that the SEC was (and still is) institutionally incapable of being an effective safety and soundness regulator of securities firms. He argues that SEC enforcement focuses instead on securities markets abuses, and its staff are trained to pursue only this mission, not to function like bank examiners and monitor closely the financial health of securities firms or their holding companies.[1] Secretary of the Treasury Tim Geithner makes similar points in his memoir.[2]

The problem with these critiques is that they contrast a fully (and effectively self-) financed system of bank oversight carried out by the Federal Reserve with an SEC whose much more limited budget has to be approved in an annual appropriations process by Congress, which devotes the fines collected by the SEC to the general budget rather than permitting the agency to keep them. If the SEC had the Fed's resources, there is no reason—at least for purposes of this hypothetical—why it couldn't have effectively applied SEIR to the investment banks it oversees.

In addition, as the law was written and still exists today, the SEC has supervisory authority over the solvency of only broker-dealers, not their parent holding companies. In the case of each investment bank that went down or nearly so, it was its holding company that failed or ran into trouble, and so any SEIR regime that would have been applied to the investment banks would have had to be implemented in my counterfactual narrative through legislative means that targeted its application for both the holding company and broker-dealer subsidiaries. In fact, shortly after banking regulators arranged the purchase of Bear Stearns by J.P. Morgan, with Federal Reserve loans and guarantees, the Shadow Committee noted that, had Bear been a bank and been subjected to an SEIR regulatory regime, the company either would not have failed or the Fed would not have felt the need to mount the rescue it did (258).

Subprime Mortgages

As for subprime mortgages themselves, not as many would have been created had policymakers not increased the guarantee ceilings on the Federal Housing Administration and Fannie- or Freddie-backed mortgages or raised the housing affordability goals of Fannie Mae and Freddie Mac in the 1990s and later. Even with these errors, however, the housing GSEs' collapse might have been avoided, had Congress applied the same kind of SEIR safety and soundness regime to them that it had imposed on banks with the Federal Deposit Insurance Corporation Improvement Act in 1991, assuming of course that the GSEs' regulator would have enforced the SEIR provisions. In combination, in the counterfactual world, subprime lending very likely would not have become the serious financial problem that it later became, nor would the housing GSEs have failed, triggering the controversial bailout that followed.

The memoirs of the key decision makers during the 2008 crisis spend much more time discussing the mechanics of financial institutions and markets and efforts to keep them functioning during periods of incredible stress than they do discussing the important contribution of poorly designed housing finance policy to the crisis.

Nondepository Financial Institutions

What about the other parts of the financial system that were involved in the crisis: the growth of credit default swaps, the failure of AIG, and even the investment banks that were not subject to higher, effectively enforced capital standards? Even if policymakers had not compelled housing GSEs to raise their affordability goals—thus encouraging the formation of so many mortgage-backed securities (MBSs) backed by subprime mortgages and the GSEs' purchases of them—the credit default swap, the financial innovation that helped make securitization of these MBSs possible by ensuring buyers against losses, still could have fueled an unsustainable growth in private-label MBSs that would have endangered the financial health of nonbanks such as AIG, Bear Stearns, and Lehman. We will never know for certain, of course, and if one or more of these financial giants still had fallen, federal authorities very likely would have come to their rescue (with the exception of Lehman, which was allowed to enter bankruptcy in any event), which would have induced Congress and the incoming Obama administration to support major legislative reform.

The largest nondepository institution to fall—or more precisely the one that triggered the largest rescue package—was AIG. Its troubles were attributable to two causes: losses from investing the proceeds of its lending securities program in securities backed by subprime mortgages and, better known, the failure of its Financial Products Group (FPG) subsidiary to set aside sufficient collateral to make good on more than $400 billion of credit default swap contracts. Clearly, FPG's counterparties mistakenly thought that AIG's sterling AAA credit rating would protect them. Compounding this error, the FPG was weakly overseen by state and federal regulators.

The FPG and any other sellers of over-the-counter (OTC) derivatives should have been required to clear them, had they been relatively standardized, through a central clearinghouse, which would have required FPG's posting adequate margin or collateral to ensure payment of the instruments. In fact, in September 2008, the Committee strongly supported the New York Federal Reserve Bank's efforts to establish such a clearinghouse (263), which Dodd-Frank later required. The Committee supported central clearing of standardized derivatives but opposed congressional efforts at the time to force clearing of customized derivatives (293), which typically involve sophisticated parties on both sides of the transactions capable of taking care of themselves. Dodd-Frank ultimately required instead that the Commodity Futures Trading Commission (CFTC) set margin requirements for nonstandardized derivatives that could not be centrally cleared.

Finally, given the importance of clearinghouses in assuring that derivatives contracts are appropriately margined and honored by all counterparties, the Financial Stability Oversight Council (FSOC) in July 2012 designated eight clearinghouses as financial market utilities (FMUs) under Dodd-Frank and thus systemically important. The Shadow Committee did not dispute these designations, which imply that these utilities are "too big to fail," but it did urge the SEC, the CFTC, and the Fed to closely monitor the clearinghouses' activities to prevent unwarranted risk-taking (351). In particular, the Committee expressed concern that the clearinghouses would relax their guard by competing with each other for business, especially by extending their activities overseas, which therefore would require foreign regulators' close attention to their activities. The Committee also called for the SEC and the CFTC to have more resources to carry out their FMU oversight responsibilities (351). At this writing, this latter suggestion does not appear to have been adopted, and that failure should be a warning to policymakers today to avoid a potential problem down the road.

Dodd-Frank in the Counterfactual World

All of this brings us to speculating about a counterfactual for Dodd-Frank, the legislative reaction to the crisis. Would it have been enacted in the form it took, or would something else have emerged from the legislative process?

To a large extent the answer to this question depends on whether the outcome of the 2008 presidential and congressional races would have been different had the 2008 financial crisis been less severe, or even had there been no crisis at all. Of course any answer here is sheer speculation. My own guess is that in 2008, Barack Obama was riding a wave of history that would have carried him to the White House regardless of how well the economy was performing.

In my view, the severity of the financial crisis had more of an effect on the outcome of the congressional elections; specifically, had the crisis been less intense, voters would have given the Democrats lower margins of control in both congressional chambers. Given the highly partisan debate on financial reform legislation that ensued, a fewer number of Democratic Senate seats in particular would have put more pressure on the administration and the Democrats in Congress to compromise with Republicans to pass any reform legislation. If either side did not make the effort—and it is certainly conceivable that this would have been the case—then no legislation may have resulted. In that event, the only post-crisis policy response might have been a tightening of regulatory supervision of banks, much as had occurred after previous banking crises, to the extent that the banking system still experienced some difficulties from any problems with private-label mortgage securities.

If, however, some legislative compromise would have been achieved, what features of Dodd-Frank might have survived? First, again depending on the severity of any banking problems, the requirements that capital standards be lifted very likely would have been included. Second, had AIG still run into financial difficulties and had the Fed injected capital into the company as it actually did, the counterfactual Dodd-Frank might have included provisions requiring clearing of standardized OTC derivatives.

Third, had Bear Stearns still required a Fed-assisted rescue from J.P. Morgan (or another bank), had Merrill Lynch been forced into the arms of Bank of America (or another bank), and had Lehman Brothers failed, even without any other large failures, the counterfactual reform legislation could have contained Dodd-Frank's provisions regarding the designation of systemically important financial institutions and the creation of the FSOC. Fourth, the financial difficulties of the aforementioned financial institutions might also have driven Congress to enact the new provisions, incorporated in Title II of the actual Dodd-Frank Act, relating to the Federal Deposit Insurance Corporation's handling of failed, systemically important nonbank financial institutions, as well as the requirement that large financial institutions prepare "living wills" to be used as guides for resolving them should they fail.

Had the crisis been less intense, voters would have given the Democrats lower margins of control in both congressional chambers.

Fifth, to the extent that the Fed had mounted one or more rescues of nonbanks, including its aggressive (and creative) use of various lending facilities to banks and primary securities dealers, any counterfactual Dodd-Frank likely would have constrained future Fed emergency lending powers under the former Section 13(3) of the Federal Reserve Act. In sum, the core features of the counterfactual Dodd-Frank, assuming any legislation were enacted at all, might very well have looked like the actual Dodd-Frank.

Given their more controversial nature, however, several provisions of the actual Dodd-Frank Act might not have been included in any counterfactual compromise bill: the creation of the new Consumer Financial Protection Bureau, the Volcker Rule prohibiting proprietary trading by banks, and the "swaps push out" provisions requiring swap activities to be conducted out of affiliates separate from banks.

To the extent that bank regulators would have gotten tougher in their examination practices after any lesser financial crisis, that turn of events would followed the pattern of prior financial crises: bolting the proverbial barn door after the horses have already left.

Indeed, even in the actual world, tougher supervision would have occurred whether or not Dodd-Frank was enacted and is often confused in the popular and political discussions of post-crisis events with Dodd-Frank itself, especially regarding the supervision of smaller banks. Whether any counterfactual crisis would have prompted bank regulators in countries participating in the Basel bank capital standards-setting process to have adopted something like Basel III is open to debate. In my opinion, had just one or two large US banks been threatened with failure in the counterfactual narrative, the Basel standards likely would not have been revised.

The Political Economy of Financial and Housing Policies

This counterfactual narrative raises a nagging question: why did policymakers not take the advice akin to what the Shadow Committee recommended, apart from implementing SEIR for depositories for about 15 years, and in the case of investment banks, why did they not apply Shadow reasoning (SEIR) to their regulation, which even the Committee failed to recommend? This question has several possible answers.

One is that policymakers mistakenly had blind faith in supervisors' ability to keep banks' risk-taking in check, while assuming that market discipline alone could be counted on to prevent excessive risk-taking by nonbanks, such as the investment banks and AIG, that failed or nearly failed and were rescued (excepting Lehman). There was no stronger believer in the effectiveness of market discipline by itself than Fed Chairman Alan Greenspan, who acknowledged this error after the crisis was underway. In short, one simple answer to the question is that policymakers made honest mistakes.

Another possible explanation for why Shadow Committee principles were not followed is that policymakers, like economic forecasters, were heavily influenced by various constituencies to maintain certain policies or courses of action—such as not clamping down on subprime lending, much of which at the time was highly popular, or containing the growth of leverage in banks and nonbanks that combined to produce the crisis. Suppose Fed Chairman Greenspan and other bank regulators had both the foresight and the willingness to tell Congress early in the 2000s or perhaps as late as 2003–04—before housing prices really rose out of line relative to incomes—that affordable housing goals should not be lifted and if anything should be cut back, that banks and nonbanks had to be watched more closely, and that any derivatives that were facilitating the growth of securities backed by nonconforming loans (private-label MBSs and CDOs) had to be cleared on centralized exchanges. Do any readers believe Congress would have listened? Given the politics of denying many new homeowners, many of them minorities, the opportunity to buy their piece of the American dream, it is likely, at least in my view, that Congress would have paid no attention. Or, if regulators took what useful actions they could have taken in advance, they would have been as heavily criticized, as the Fed is now for rescuing the creditors of the major financial firms that later failed.

A third explanation—outlined best by Raghuram Rajan, a former chief economist of the International Monetary Fund and the head of the Central Bank of India, now back at the University of Chicago—is that the financial system and the policymakers who attempted to govern it responded rationally to subprime borrowers' demand for mortgage credit to compensate for the slow growth in their incomes during the 2000s.[3] This explanation ignores other factors that helped make this lending possible, including lax mortgage underwriting standards, incentives for acquiring subprime loans created by the affordable housing goals, poor oversight by the credit rating agencies and bank supervisors, and complexity of the mortgage securities that made it difficult for the credit raters and investors to understand them. The Rajan explanation also overlooks that excessive leverage magnified the downward impact of the subprime delinquencies when housing prices began to collapse around 2006 and later. But it still makes a good point that strong demand for subprime loans, driven in part by wage stagnation in the middle and bottom of the income distribution, contributed to the crisis, and it also helps explain why policymakers did not take the kind of advice advanced by the Shadow Committee.

Fourth, to the extent that excessively loose monetary policy in the years before housing prices peaked contributed to the crisis, it is unlikely that this source of the crisis would have been any different in a counterfactual world in which Shadow Committee policies had applied.

In sum, the political economy of the crisis, overlooked by many commentators, helps explain why seemingly sensible policy measures, such as those advocated by the Shadow Committee and others, were never adopted. Likewise, the strong regulatory reaction to the crisis is also consistent with the political economy of reactions to previous crises.

Notes

1. Ben Bernanke, *The Courage to Act* (New York: Random House, 2015).
2. Timothy Geithner, *Stress Test: Reflections on Financial Crises* (New York: Broadway Books, 2014).
3. Raghuram Rajan, *Fault Lines: How Hidden Fractures Threaten the World Economy* (Princeton, NJ: Princeton University Press, 2011).

XVI. The Role for Market-Based Financial Policy in the Future

If you have made it this far, a natural question you may have, whether or not you agree with the Shadow Committee's many statements on financial policy through the years, is what could drive future decision makers to embrace more market-based financial principles and policies of the kind that the Committee has advocated in the past. In this concluding chapter, I offer my answers to this and similar questions, fully realizing that many former Shadow Committee members may not agree with some, or perhaps all, of those answers.

The broad answer to the question just posed is hidden in plain sight, as it were (and to borrow an expression in the title of a book about the financial crisis written by former Shadow member Peter Wallison).[1] By this, I mean that certain aspects of the Dodd-Frank Act and regulators' response to the crisis can be construed, as least in my opinion, as being consistent with market-based regulation or facilitating the orderly functioning of financial markets. So, too, can be the delayed but strong reaction to the "too big to fail" (TBTF) problem. I know my interpretation of parts of Dodd-Frank as being consistent with market-based principles will seem counterintuitive (and probably wrong) to some, so bear with me as I believe the case is strong.

I include a word of caution, however, that some ongoing reactions to the crisis can overdo it and lead to new problems down the road. The quest for sound financial policy is thus sure to continue. Indeed, I close this book by listing (in some cases again) several issues that likely will be presented for resolution at some point in the future, coupled with my speculations about how the Shadow Committee would address them.

Capital Requirements

Begin with higher capital requirements that regulators worldwide have imposed on all banks under the latest version of the Basel standards, Basel III. Put aside the defects of the Basel process and the contents of the standards (the arbitrariness of the risk weights, the failure to take account of portfolio risks, and so on, discussed in earlier chapters). The net result of Basel III is that even when capital-asset ratios are computed without the risk weights assigned to different asset classes under the Basel standards, capital ratios for the banking system as a whole and for larger banks in particular (those with assets above $50 billion) are considerably higher than they were before the crisis.[2]

I did not pick the $50 billion asset threshold by accident. The number was enshrined in Dodd-Frank as the minimum size that would trigger the Financial Stability Oversight Council (FSOC) to designate a bank as a systemically important financial institution (SIFI). Under the act, such SIFIs are subjected to tougher supervisory scrutiny and higher capital ratios than other banks. Regulators in the United States since have required bank SIFIs to maintain a risk-weighted capital ratio of at least 1 and potentially 4.5 percentage points higher than smaller banks. The US rules parallel the latest Basel rules.

In October 2015, the Federal Reserve Board proposed that global systemically important banks meet new "total loss absorbing capacity" requirements, which can be met with either conventional equity or contingent convertible bonds (CoCos), which regulators can compel to be converted to equity if the banks run into trouble. Although, at this writing, this proposal has not yet been adopted, the Shadow Committee can take some credit for the CoCo proposal.

Well before the idea was floated, the Committee anticipated the nature of a CoCo contract—a conversion of debt into equity—by suggesting the idea of a catastrophe bond to finance a portion of bank assets (278, 289). This instrument would behave like a conventional bond during normal times, but would not be repaid in the event the bank failed or had to receive emergency government assistance. This idea is very much like a bond that converts to equity upon some external indicator of distress.

Charles Calomiris and Richard Herring, two of the Committee's longtime members, published academic papers well before the FSB outlined the CoCo concept and the rationale for it in some detail. The Committee itself issued a statement in December 2010 outlining the specifics of a CoCo plan (303) and later congratulated regulators in a December 2015 statement for proposing a variation of the CoCo idea (361).

However, the Calomiris/Herring and Shadow Committee CoCo proposals differ in one important respect from the kinds of instruments that the FSB has suggested. Under the FSB's approach, regulators retain discretion over when to force conversion, which allows some room for forbearance. In contrast, the bonds Calomiris/Herring and the Shadow Committee proposed would automatically convert to equity if the 90-day moving average of the market value of the equity in the bank or its holding company divided by its assets (a market-value-based capital-to-asset ratio) falls below a minimum but positive threshold. The trigger would be set at a sufficiently high level—perhaps as high as 10 percent of the moving average of the market value of the bank—so that the bank has sufficient options to recapitalize or restructure on its own well before it hits the trigger. The concept of the moving average is important to prevent "gaming" by shareholders (such as short selling that could force the debt-to-equity conversion) and also to avoid premature conversions that anomalous short-term movements in stock prices might trigger.

Although regulators have not yet adopted CoCos with an automatic conversion feature, the CoCo bonds they envision still move in the right direction by ensuring that large banks maintain an extra cushion against loss in addition to the higher-equity capital regulators have already mandated. It should be noted that CoCos are also a variation of an idea that the Shadow Committee has long advocated: a requirement that banking organizations above a certain size issue long-term debt that cannot be immediately redeemed. CoCos are superior to subordinated debt because of the equity conversion feature.

Some commentators have urged regulators to dispense with CoCos, which they claim only complicate matters, are not "real capital," and simply require more equity capital. In fact, several Committee members have advocated in their writings higher equity cushions for *all* banks, not just SIFIs (a concept that the Committee itself has criticized). The Committee as a whole expressed concern in the past that doing so would unduly raise banks' cost of capital and therefore embraced the subordinated debt concept because the interest payments on this debt are tax-deductible, while dividends on straight equity are not. At the same time, subordinated debt (sub debt) provides an extra layer of protection against loss—to be absorbed by the sub debt holders—before depositors or the Federal Deposit Insurance Corporation (FDIC) are threatened.

Critics of CoCos might be expected to respond: given the costs of the 2008 financial crisis and, in particular, of excessively leveraged banks, why should we care that additional equity would be more expensive than either sub debt or CoCos? Indeed, the very fact that equity is more expensive than debt should induce the largest banks, which would have to comply with higher capital requirements, to shrink faster than they otherwise might.

I leave deciding the CoCos versus equity debate to others, since it is a close call. I will note, however, that the higher capital requirements already in place are inducing large banks to discourage new and existing customers from placing deposits with them (which raise the shareholders' equity the banks must have) and, in some cases, actually to shed assets. Federal Reserve Chair Janet Yellen has applauded these developments, which shows how capital rules can at least partially offset the moral-hazard dangers associated with the designation of large banks as systemically important.

Some in both political parties still want more: to break up the largest banks as a separate matter from reinstating the Glass-Steagall Act (as already discussed), whether by fiat or by raising bank capital requirements much above where they are now so that this would be inevitable result. For example, one prominent proposal of the latter type has been offered by former Senator Scott Brown (R-MA) and current Senator David Vitter (R-LA), requiring large banks to meet a minimum leverage ratio of at least 15 percent, much higher than the current 6 percent. Some scholars have argued for even higher mandatory capital ratios.

One problem with this idea, of course, is that unless other countries were to also raise mandatory capital ratios, presumably within the Basel framework, US banks would be put at a competitive disadvantage vis-à-vis foreign banks. This argument was more compelling, at least to US policymakers, before the financial crisis, but it still has some weight. It is not decisive, however. If the United States prefers to pay the price of not having its largest banks be competitive in some global lending markets—those tapped by the largest nonbank borrowers—as a way of making its financial system safer, I am prepared to accept that trade-off, and I suspect that a lot more people (including policymakers) agree with that view than would have before the 2008 financial crisis.

The second problem with significantly higher bank capital requirements than those that are already scheduled is a more serious one: moving in this direction could push some, if not much, lending by large TBTF banks onto the balance sheets of less-regulated nonbank lenders, such as finance companies and money market funds holding commercial paper that are not also designated as SIFIs. The analogy here is that risk cannot be pushed out of the financial system but can be pushed around much like air in a balloon. If more of it goes to a less-regulated part of the economy, it is not clear that the overall financial system becomes safer.

One possible response to this balloon-shifting argument would be to regulate the shadow banking system more heavily, through higher capital requirements and bank-like examination and supervision. As I discussed earlier, I am sympathetic with additional regulation of investment banks, in particular, if it is designed to discourage such heavy reliance on short-term (especially overnight) wholesale funding. But I have not yet made it to the position that in the impossible quest to root out all possible systemic risk in the financial system policymakers should impose much stiffer additional regulation on the entire shadow banking sector.

Breaking Up the Banks?

In short, to the extent TBTF banks continue to downsize because the existing capital requirements, supplemented with the proposed CoCo addition for SIFI banking organizations, induce them to shrink, then that outcome should be welcomed. In addition, under Dodd-Frank, bank regulators have the authority to compel breakups of banking organizations if they are dissatisfied with their "living wills"—namely, if the banks cannot be "resolved" in a future crisis without putting financial regulators at an undue risk of having to rescue their uninsured creditors. Those who would go further and *preemptively* break up large banks have at least two stiff hurdles to overcome.

First, regulators must offer a plan that includes a size threshold for triggering the breakup of any banking organization; the threshold must have some reasonable rationale and not be simply an arbitrary cutoff. Otherwise, Congress could be open to a Constitution-based legal challenge that shareholders of organizations subject to the breakup plan have been deprived of their property without due process of law or reasonable compensation. I have yet to see such a plan or its rationale.

Second, it is not enough to argue that even if the size cutoff is arbitrary, the financial system and the broader economy will be better off with more \$50–100 billion, or even \$250–500 billion, banks than it is with a few whose assets now exceed \$1 trillion (341). By "better off," I am inferring that the financial system would be less susceptible to contagious deposit runs (the TBTF problem with another name).

But on what basis can one claim that uninsured depositors at multiple medium-sized banks are less likely to run during a crisis than those at a few much larger ones? During the less-developed countries (LDC) debt crisis in the 1980s, by not forcing banks to mark their loans to LDC sovereigns and other borrowers to market, regulators engaged in a massive program of forbearance that effectively permitted most or all of the largest banks at that time, each of which had a much smaller share of nationwide bank deposits than the largest banks do today, to continue operating. Bank regulators did this out of fear that any effort to close down the capital-short or insolvent banks or to force them to raise substantial amounts of new equity could have sparked a major run on the deposits of all of the banks.

The 1980s episode starkly illustrates how regulators could easily find themselves in the same circumstances today or in the future—compelled to invoke the systemic risk exception under the Federal Deposit Insurance Corporation Improvement Act to provide financial assistance to these banks to make large creditors whole—if policymakers broke up the largest banks today into pieces roughly the size of (or perhaps even smaller than) the top 10 banks that dominated the US banking landscape more than three decades ago. Put differently, multiple $250 billion or even $100 billion banks resulting from any breakup plan could easily be deemed TBTF in the future. What, then, would be gained by breaking up the big ones now?

One possible reply might be that each of the smaller broken-up banks would have less political clout with legislators and regulators than the few $1 trillion-plus banks do today. But the largest banks already participate in a trade association with other large financial institutions, and there is no lawful way of preventing the multiple broken-up institutions from doing the same. In effect, in a post-breakup world, the banks' trade associations would gain more political power than the individual banks, but the combined political power of large banks would very likely be much the same as now.

Breakup advocates also note that big banks, which have been the champions of lending to smaller businesses than those that regional and smaller banks have lent to, have cut back substantially on their lending to small business over the past decade. Accordingly, breaking them up arguably could lead to more lending to small businesses.

The very fact that equity is more expensive than debt should induce the largest banks, which would have to comply with higher capital requirements, to shrink faster than they otherwise might.

Even if that outcome were to occur, it is not clear that the net economic impact necessarily would be positive (although the current politics seem to favor such a result). In particular, larger businesses by definition tend to enjoy economies of scale that smaller businesses do not. I have also yet to see a study documenting that smaller businesses are more innovative than their larger counterparts.

If instead the argument were couched and documented in terms of lending to new *businesses*, which historically have been responsible for much, if not most, net new-job growth and which also have been disproportionately responsible for the kind of disruptive innovations that drive productivity growth, then I would be more sympathetic. But banks generally have not been major sources of financing for new ventures, except indirectly through founders borrowing on bank-supplied credit cards or home-equity lines of credit, because they lack collateral. The nation's largest banks certainly continue to be major players in these lending markets, although less aggressively than before the 2008 financial crisis, which is understandable and defensible.

Multiple $250 billion or even $100 billion banks resulting from any breakup plan could easily be deemed TBTF in the future.

The "break up the banks" movement was preceded by an earlier proposal by the Obama administration in 2010 to tax large banks to help defray the costs of the Troubled Asset Relief Program (TARP). The Shadow Committee did not object to this idea in principle, but it critiqued the administration's plan for unfairly singling out large banks to contribute when TARP was being used for injecting capital into not only banks but also nonbank financial companies and auto companies. In addition, in early 2010, the Committee argued that it was premature to set the tax before the net cost of TARP was known (284). As it has turned out, as of March 2015, the Congressional Budget Office had estimated that this number would likely fall under $30 billion, a figure far below TARP's original $700 billion—and even that number could fall as more repayments, with dividends, are made.[3] Looking ahead, the Committee urged that a federal agency such as the Office of Management and Budget systematically estimate and publish the annual cost of the implicit subsidies provided by federal financial guarantees (285).

The Committee weighed in again in May 2014 on the use of taxes to induce large banks and other large nonfinancial SIFIs to shrink, while punishing them for past behavior and raising money for the federal government (352). This time, the Committee most explicitly opposed such a tax as a blunt instrument, especially when capital requirements, risk-based deposit insurance, and stress tests were already in place (at least for banks).

In sum, I have yet to find a specific large bank breakup or even a tax plan that rests on a solid rationale. However, shrinkage of the largest banks due to current higher capital standards for SIFI banks imposed by regulators and the market is already underway. I could even support capital standards that are modestly higher still, although substantially higher capital requirements than those now in place are more problematic, in my view, and run a significant risk of pushing customers to borrow from less-regulated nonbank lenders.

Other Market-Facilitating Elements of Dodd-Frank

Switching gears and moving back to market-like regulation embedded in Dodd-Frank, its mandate that standardized derivatives trades be centrally cleared is another example of a rule that facilitates orderly markets in much the same way that other legal rules relating to property definition and contract enforcement facilitate market transactions and instill trust in commercial transactions by private actors. Over-the-counter derivative markets today are safer (and, in the case of credit derivatives, much smaller in total volume) than they were pre-crisis.

Dodd-Frank's direction to regulators to force changes in bank compensation structures, which has led to requirements that trader compensation, in particular, be stretched out over multiple years, also may unintentionally prove to benefit the real economy by encouraging more young people who otherwise would pursue Wall Street careers instead to seek out entrepreneurial opportunities in the rapidly expanding and potentially disruptive (in a good, "Schumpeterian" way) area of fintech (financial technology). This term refers to the many new technology-related startups in the financial arena, including those involved in creating new digital currencies, peer-to-peer lending, and crowdfunding platforms for startups seeking equity funds from investors who may not meet accredited investor requirements.

On the other hand, depending on the outcome of the 2016 presidential election and party makeup of the next Congress, we could see more financial regulation, especially of institutions in the shadow banking system that rely heavily on short-term funding. It is too early to predict, however, what form this regulation might take, which regulators would implement it, and whether Congress would enact legislation leading to these reforms.

Two market-oriented items in Dodd-Frank, one more disputed than the other, remain untested—until the next crisis. One of these—Title II of the act, which puts the FDIC in charge of resolving SIFIs and banks—has been especially controversial. Since the act became law, the FDIC has announced it will implement this provision by haircutting investors and creditors of financial holding companies and, if necessary, putting them out of business, while keeping their operating subsidiaries functioning, unless their net worth is negative. This approach has been called the "single point of entry" method of resolving failed financial firms.

Critics of Title II nonetheless point to the FDIC's ability under this approach to borrow from the Treasury if necessary in a crisis, which could make uninsured creditors whole, thereby creating moral hazard. This a legitimate concern, but one whose importance is impossible to assess accurately unless and until the FDIC is tested in a future crisis. Even so, it is important to note that the costs of such lending, if not fully repaid or extended at below-market rates, are to be borne in the future by the financial industry and presumably its customers, rather than taxpayers.

Title II, meanwhile, has effectively substituted the Treasury and the FDIC as sources of institution-specific creditor support for the Federal Reserve, which, until Dodd-Frank, provided emergency loans to specific nonbanking organizations under Section 13(3) of the Federal Reserve Act. Dodd-Frank limited the Fed's Section 13(3) emergency lending powers to programs of "broad-based eligibility," intended to rule out institution-specific loans. In November 2015, the Fed approved a rule implementing this provision, modeled on legislation proposed by a politically odd couple, Senators Elizabeth Warren (D-MA) and David Vitter (R-LA). The bill and the Fed's rule allow emergency lending by the Fed only if at least five specific firms, none insolvent, are eligible for the loans.

The ongoing criticism of TBTF from both ends of the political spectrum suggests the future of market-based financial policy is bright.

Market critics argue that even this limitation on the Fed's powers is not strict enough to end TBTF, and as evidence they might note that nearly all of the lending facilities the Fed established during the 2008 crisis very likely would have qualified under the Fed's new emergency lending rule (although it is unclear whether the institution-specific guarantees the Fed gave AIG's creditors would have qualified). At this writing, there are congressional proposals to further limit the Fed's emergency lending powers by requiring supermajority approval by the Fed governors and Federal Reserve Bank presidents before the loans are extended. Others want to curtail or eliminate the Treasury's ability to lend money under Title II of Dodd-Frank to specific failing SIFIs under FDIC conservatorship if such loans are deemed necessary to prevent systemic risk. The ongoing criticism of TBTF from both ends of the political spectrum suggests the future of market-based financial policy is bright.

More broadly, the TBTF critiques and the policy proposals they have engendered remind me of a more general prediction made by my former Kauffman Foundation colleague Brink Lindsey, who now directs research at the Cato Institute, that other market-friendly policy measures may be in store. Lindsey argues that slow economic growth since the 2008 crisis may prompt the formation of other unusual political alliances to tackle what he correctly labels as "regressive regulation" that protects incumbents (mostly upper-income) from competition, which impedes more rapid growth.[4] Lindsey's antigrowth combinations include excessive protection of intellectual property rights, restrictions on high-skilled immigration, excessive occupational licensing, and artificial scarcity created by local land-use regulation.

Just as bad economic times during the late 1970s and 1980s provided a fertile backdrop for the unusual alliances that resulted in the deregulation of airline and trucking fares and routes, as well as the breakup of AT&T, Lindsey asserts that slow growth now may generate another unorthodox alliance that will roll back the entry barriers in each of the four foregoing policy arenas. By the same reasoning, the anger generated by the financial rescues of TBTF institutions during the 2008 crisis seems to have given life to at least some of the market principles the Shadow Committee has long championed in the financial arena, especially as they relate to ending TBTF to significantly curtail moral hazard.

I personally am not convinced, however, that further hamstringing the emergency lending authorities of the Fed and the FDIC/Treasury under Title II of Dodd-Frank, as some are now urging, is the right sort of market-friendly response to TBTF. The playing field on which banks compete could be leveled by an entirely different sort of policy—lifting the current dollar cap on insured bank deposits for all banks coupled with a tightened structured early intervention and resolution (SEIR) policy that raises the capital threshold at which regulators have the authority to put troubled banks (and savings institutions) into receiverships or other hands. Such an approach would prevent all bank runs and address moral hazard (through stricter SEIR provisions), without running the unknowable systemic risks of further narrowing current emergency lending authorities.

I realize, of course, many (or even most) current Shadow Committee members might prefer a different course. But I do recall that during some of the Committee discussions in the past, one of the original Shadow Committee members, the late George Benston, took a position very much like the one I have just advanced here.

What's Next? And What Would the Shadow Committee Say?

There is, of course, much other unfinished business in the financial policy arena aside from what to do about TBTF. I conclude here by briefly mentioning five issues I believe cannot be avoided, together with some thoughts on how I believe the Shadow Committee would address them if it were still in place.

First, the SIFI designation process could change if MetLife ultimately wins its lawsuit (after all appeals are exhausted or dropped) or if Republicans win the presidency in 2016 and change Dodd-Frank. At a minimum, I anticipate that Congress would lift the minimum automatic size threshold for bank designation above the current $50 billion. As for nonbank designations, the FSOC may be forced by the courts or by Congress into being more transparent in how it makes them.

Readers should be aware by this point, however, that the Shadow Committee has opposed the very idea of SIFI designations on the grounds that stiffer capital standards for SIFI institutions cannot offset the moral-hazard impact of formally identifying an institution to be systemically important. It is conceivable that a future Congress could follow this advice, but I doubt it. Indeed, if the United States were to experience another major financial crisis—not simply another recession—there very likely would be a groundswell of support for not only keeping SIFI designations but also regulating the institutions so designated even more tightly. Even that may prove to be insufficient: calls for breaking up large financial institutions would be even louder than they are now, whether directly through a legislated asset ceiling (or some other metric, such as market share, as in the Riegle-Neal Banking and Branching Efficiency Act) or indirectly through much higher capital requirements for SIFI institutions that would compel more downsizing than has already taken place. It is conceivable under some post-2016 election scenarios that even in the absence of another crisis, breakup legislation of some type could be enacted and signed into law under a future Democratic president (with support of some populist Republicans).

Second, it is only a matter of time before the nonbank failure resolution process in Title II of Dodd-Frank is tested by another failure of a systemically important nonbank financial institution. If Treasury financing turns out to be necessary, even if other large financial institutions pay back the money by an assessment as Title II envisions, it is likely that emergency aid would reignite the debate over TBTF. In that environment, support for a credible, special bankruptcy procedure for nonbank financial institutions may be sufficiently strong that Congress uses it to replace the current Title II FDIC-led resolution procedure. That outcome certainly would be consistent with prior Shadow Committee statements on appropriate resolution procedures for nonbank financial firms. I would be comfortable with a special bankruptcy process, but only if that procedure allowed for emergency federal financing, analogous to what is now in Title II, to prevent a crisis at one financial firm from snowballing into a larger crisis.

Third, eventually a future Congress and president are likely to decide what to do about Fannie Mae and Freddie Mac: restore them to their former role, perhaps with a reduced affordable housing obligation; morph them into mortgage reinsurers; or phase implicit federal support for them out entirely, most likely through a gradual reduction of the conforming limit on mortgages the government-sponsored enterprises (GSEs) can purchase or guarantee (but implicitly allowing the Fed to assist the mortgage market in a future crisis by buying mortgage securities). The Shadow Committee in the past has consistently favored the third alternative, although Committee members may disagree about how willing the Fed should be to support the mortgage securities market in a future crisis.

Given what has happened with Fannie and Freddie, I have much sympathy with this position, provided it is understood that the Fed would have the right, if not the obligation, to help bolster the mortgage securities market in a future crisis. I would couple a gradual phaseout of the GSEs with a phased-in transformation of mortgage interest and property tax deduction (which is regressive) into a tax credit or with a capping of all deductions as a percentage of adjusted gross income.

It is only a matter of time before the nonbank failure resolution process in Title II of Dodd-Frank is tested by another failure of a systemically important nonbank financial institution.

Fourth, earlier I expressed my discomfort with the continued heavy reliance of some nonbank financial institutions on very short-term financing, through either commercial paper or, more commonly, repurchase agreements (repos). The Fed shares this concern and has proposed additional collateral requirements on repo borrowings. I am not sure whether this is the best approach, rather than a simple limit expressed as a percentage of total liabilities (including off-balance-sheet exposures). Nor am I sure how the Shadow Committee would address this issue or even if it would recognize it to be a problem that requires a solution.

Finally, despite the large additional regulatory responsibilities that Dodd-Frank gave the Fed, I do not believe that the act settled for all time whether the Fed should retain twin monetary control and financial supervisory roles. Again, in a future crisis, if it turns out that Fed supervisors failed to prevent the failure of one or more SIFIs, a political backlash could result in the Fed's having to drop its regulatory functions. This, of course, is what the Shadow Committee has previously recommended, and it is an outcome that is not as unthinkable as it once might have been. Indeed, given another backlash, some Fed governors or a future chairman may prefer to drop the institution's regulatory functions as a price for continued independence of its conduct of monetary policy.

Hopefully, policymakers will draw some useful lessons from the cumulative body of Shadow Committee statements that have been summarized and analyzed here in addressing these five issues, and possibly others, that are likely to demand their attention in the future.

Notes

1. Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why It Could Happen Again* (New York: Encounter Books, 2015).

2. For example, the unweighted capital-to-asset ratio for all US banks was 9.57 percent in 2010. By mid-2015, it had risen to 10.7 percent. See FDIC, *Quarterly Banking Profile: Second Quarter 2015*, Vol. 9, no. 3 (2015): 18, https://www.fdic.gov/bank/analytical/quarterly/2015_vol9_3/FDIC_2Q2015_v9n3.pdf. The largest systemically important banks must also, by law and regulation, maintain higher capital ratios than other banks.

3. Congressional Budget Office, *Report on the Troubled Asset Relief Program*, March 2015, https://www.cbo.gov/publication/50034.

4. Brink Lindsey, *Low-Hanging Fruit Guarded by Dragons: Reforming Regressive Regulation to Boost U.S. Economic Growth*, Cato Institute, June 22, 2015, http://www.cato.org/publications/white-paper/low-hanging-fruit-guarded-dragons-reforming-regressive-regulation-boost-us.

Appendix

US Shadow Financial Regulatory Committee Statements

For a full list of all the Shadow Financial Regulatory Committee statements, see Shadow Financial Regulatory Committee, "Shadow Financial Regulatory Committee Statements," Loyola University Chicago, http://www.luc.edu/quinlan/finpol/shadowfinancialregulatorycommitteestatements/.

1. The Baker Plan and LDC Lending
2. Aid to Failing Banks
3. Federal Reserve Ruling on Junk Bonds
4. Disclosure of Supervisory Actions Examiners' Ratings
5. Disclosure by Regulated Financial Institutions
6. Proposals for Risk-Related Bank Capital Guidelines
7. Capital Forbearance Policy for Agricultural and Energy Banks
8. Recapitalizing FSLIC and Zombie S&Ls
9. Proposal to Facilitate the Interstate Takeover of Failing Depository Institution
10. Federal Home Loan Bank Board (FHLBB) Proposed Rules on Regulatory Capital and Nationwide Lending by Insured Savings and Loan Associations
11. Federal Regulation of Activities of State-Chartered Financial Institutions
12. Conversion of S&Ls from FSLIC to FDIC Insurance Coverage
13. Current Bank Holding Company Applications for Increased Securities Activities
14. Policies Toward Troubled Depository Institutions
15. Proper Financing of Private Party Securities Fully Guaranteed by the Federal Government
16. FSLIC Recapitalization
17. The Federal Reserve Board's "Source-of-Strength" Policy
18. Regulatory Proposals for Risk-Related Capital Standards (Rev.)
19. Supplementary Statement: Regulatory Proposals for Risk-Related Capital Standards
20. Unnecessary Costs of FSLIC Recapitalization Program
21. International Debt
22. FSLIC Handling of Insolvent Thrift Institutions
23. Brady Commissions and Recent Market Events
24. The Federal Reserve Board's Request for Comment on the Acquisition of Healthy Thrift Institutions by Bank Holding Companies
25. Moratorium on Bank Securities Activities

26. Studies of the Stock Market Crash
27. Disposal of FDIC Equity Interests in Assisted Banks
28. The Southwest Plan for Ailing Thrift Institutions
29. Regulatory Proposal for Risk-Related Capital Standards
30. Disclosure by Financial Institutions of Financial Assets and Liabilities
31. FDIC's New Policy on "Whole Bank" Takeovers
32. Proposed FDIC Policy Statements Encouraging Independent Outside Audits of Banks
33. Policy Responses to the Stock Market Crash
34. FSLIC's Handling of Failed Thrifts
35. The Need to Make FSLIC and FDIC Assistance Deals Accountable
36. The Need to Estimate the True Economic Condition of the FDIC
37. Assessing FDIC Premiums Against US Banks' Unsubordinated Debt and Deposits in Foreign Branch Offices
38. An Outline of a Program for Deposit Insurance Reform
39. The Administration's Plan to Resolve the Thrift Crisis
40. Risk-Based Capital and Early Intervention Proposal of Federal Home Loan Bank Board
41. An Outline of a Program for Deposit Insurance and Regulatory Reform (Revision of No. 38)
42. The On-Budget Status of Expenditures to Resolve Thrift Insolvencies
43. Financial Institutions Reform, Recovery and Enforcement Act of 1989
44. The Comptroller of the Currency's Proposal for a Minimum Bank Leverage Ratio
45. Federal Reserve Proposal to Modify the Payments System Risk-Reduction Programs
46. Proposals to Modify Loan Loss Reserves for Third-World Debt
47. Congressionally Mandated Accounting for Junk Bond Sales
48. The Activities of the Resolution Trust Corporation
49. Latin American Debt
50. Capital Standards for Member Banks
51. Proposal to Curb Stock Market Volatility
52. The FDIC's Proposed Regulation on Purchased Mortgage Servicing Rights
53. Subsidized Federal Reserve Assistance
54. The Failure of the Treasury's Study of the Federal Deposit Insurance System to Focus on Identifying and Correcting Defects in Government Incentives
55. RTC Thrift Resolution Policies
56. The Elimination of Restrictions on Bank Securities Activities and Affiliations
57. Proposals to Consolidate the SEC and CFTC
58. Provision of Seller Financing by RTC in Asset Sales
59. Condition of the Bank Insurance Fund
60. RTC Property Disposition Policies
61. Limiting Taxpayer Loss Exposure in Government-Sponsored Credit Enterprises
62. Congressional Intercession with the Financial Regulatory Agencies
63. National Branching
64. FDIC Ownership of Continental Illinois Stock

65. [Missing]
66. Proposals to Inject Additional Funds into the Bank Insurance Fund
67. Concerns About the Availability of Bank Credit
68. OTS Proposal for Capital Requirement for Interest Rate Risk
69. FASB's Proposed Statement of Financial Accounting Standards Concerning "Disclosures About Market Value of Financial Instruments"
70. Funding of the BIF and Depository Insurance Reform Proposals in H.R. 2094
71. Need to Develop a Satisfactory Data Base with Which to Analyze the Economic Condition of Insurance Companies
72. OMB and CBO Statements Calling for More Informative Accounting and Budgeting for Deposit Insurance
73. Additional Comments of Deposit Insurance Reform Legislation
74. Bank of Credit and Commerce International
75. Protecting Taxpayers from Risks of Government-Sponsored Enterprises
76. FDIC Improvement Act of 1991
77. Accounting for Taxpayers' Stake in the FDIC's Bank Insurance Fund
78. United States Listing Requirements for Foreign Companies
79. Interagency Policy Statement on Commercial Real Estate Loans
80. FDIC's Program for "Hospitalizing Sick Banks"
81. Using Risk-Related Capital Standards to Promote Housing
82. Need to Regulate Interest Rate Risk
83. The FDIC's Proposed Schedule of Risk-Sensitive Premiums
84. Brokered Deposits and Capital Requirements
85. The TDPOB's Proposed Early Resolution/Assisted Merger Program
86. SEC Listing Requirements for Foreign Securities
87. Rule Proposed by Bank Regulators to Control Interest Rate Risk
88. Proposed Rule on Interbank Exposure
89. Standards for Safety and Soundness
90. An Open Letter to President Clinton
91. Proposed Changes in the FDIC's Risk-Related Premium System
92. FDIC Action on Critically Undercapitalized Banks
93. Taxpayer Risks in the Pension Benefit Guarantee System
94. The Policy of Authorizing "Minimal Documentation" Loans
95. "Fair Value" Reporting for Insured Depository Institutions Required Under FDICIA
96. Modifying Risk-Based Capital Standards to Account for Interest-Rate Risk
97. FDIC Pilot Reinsurance Program
98. The New Depositor Preference Legislation
99. Proposals to Permit Banks to Branch on an Interstate Basis
100. The Proposed Federal Banking Commission
101. Safety and Soundness Standards
102. Deterioration in the Financial Condition of the Pension Benefit Guarantee Corporation

103. Principles of Regulatory Restructuring
104. Mutual to Stock Conversions of Thrift Institutions
105. Proposed Revisions to Community Reinvestment Regulations
106. Proposed Lengthening of Examination Schedules and Required Independent Audits for Thrift Institutions
107. Federal Displacement of State Laws: Fair Credit Reporting and Interstate Branching
108. Proposed Increases in FHA Insurance Limits
109. Financial Accounting Standard 115
110. Final Rules on Incorporating Concentrations of Credit Risks into Risk-Based Capital Standards
111. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
112. Regulatory Agency Measurement of Bank Capital for Prompt Corrective Action
113. Proposed Community Reinvestment Act Regulations
114. FDIC Insurance Assessments
115. Repeal of the Bank Holding Company Act and Restrictions on Product Diversification for Banking Organizations
116. Open Letter on Financial Reform to the Senate and House Banking Committees
117. Emergency Assistance for Mexico
118. Principles of Bank Reform: Guidelines for Assessing Pending Legislative Proposals
119. Wholesale Banking Proposal Under H.R. 1062
120. The Leach Bill
121. Proposed Amendments to Part 5 of the Regulations of the Office of the Comptroller of the Currency
122. Federal Reserve Proposal for Pricing Daylight Overdrafts
123. Alternatives to Recapitalizing the Savings Association Insurance Fund
124. The Banking Agencies' Proposed Interest Rate Risk Capital Standards
125. Alternatives to Recapitalizing the Savings Association Insurance Fund and Defeasing the FICO Bonds
126. Values of Bank Capital Tripwires for Prompt Corrective Action and Least Cost Resolution
127. Reduction in Premiums for BIF-Insured Institutions
128. Bank Merger Law and Policy
129. Ownership of Stock by Bank Directors
130. Expansion of Bank Powers by Regulation
131. Extending the Credit Reform Act to GSEs
132. Disclosure of Examination Reports and Ratings
133. Proposed Legislation on Enterprise Resource Banks (The "Baker Bill," H.R. 3167)
134. A Proposal for Privatization of the Federal Home Loan Bank System
135. [Missing]
136. Recent Fed and OCC Rulings on Permissible Bank Activities
137. Bank Activities and the Extension of Bank Subsidies
138. Restrictions on Banking-Commerce Affiliations
139. H.R. 10 ("Leach Bill") and the Commerce Subcommittee Draft
140. Mortgage Lending by Federal Home Loan Banks
141. Strategic Plans of Federal Financial Institution Regulatory Agencies

142. Congress and Financial Reform
143. Sweep Accounts and the Prohibition on Paying Interest on Reserve Balances and Demand Deposits
144. Expanded Powers for Federal Home Loan Banks
145. International Monetary Fund Assistance and International Crises
146. The Credit Union Membership Access Act, H.R. 1151
147. Mergers and Acquisitions in the Banking Industry
148. Principles for Reforming the "Global Financial Architecture"
149. The Use of Private Credit Ratings for Determining Capital Requirements for Securitizations
150. The Senate Version of H.R. 10
151. The Issues Posed by the Near-Collapse of Long-Term Capital Management
152. The G-7's New Precautionary Credit Line Facility for the IMF and Its Use in Brazil
153. The Federal Reserve Board and Prudential Supervision
154. Revising the Basle Capital Standards
155. The Latest Round of Bills on Financial Modernization
156. The Basel Committee's New Capital Adequacy Framework
157. The Failures of BestBank and First National Bank of Keystone
158. Proposed Federal Catastrophe Reinsurance
159. Federal Home Loan Banks
160. Reforming Bank Capital Regulation
161. Proposal on Full Cost Pricing of Supervisory and Examination Services by the Federal Banking Agencies
162. Proposal to Increase Deposit Insurance Coverage to $200,000
163. The Regulation of Derivative Instruments
164. Privatizing the Housing GSEs
165. Deposit Insurance Reform Options
166. An Open Letter to the New President and Congress on an Agenda for Financial Reform
167. Comptrollers' Proposed Pilot Program Permitting Increased Lending Limits for Community Banks
168. Requiring Large Banks to Issue Subordinated Debt
169. The Basel Committee's Revised Capital Accord Proposal
170. Optional Federal Chartering of Insurance Companies
171. Assuring Discipline of the Housing GSEs
172. Terrorism Insurance
173. Predatory Lending
174. The Gramm-Leach-Bliley Act
175. Deposit Insurance Reform
176. Enron and Accounting Issues
177. Pension Reform in the Wake of Enron's Collapse
178. Statement on Shay-Marky Bill on GSE Disclosure
179. The Basel 2 Approach to Bank Operational Risk
180. The Responsibilities of Independent Auditors to Shareholders of Publicly Traded Corporations
181. Fannie Mae's Duration Gap
182. A Proposed Federal Backstop for Terrorism Insurance and Reinsurance

183. SEC Standards for Designating Nationally Recognized Credit Rating Organization
184. Statement on Disclosure of Portfolio Holding of Registered Investment Companies
185. A Financial Agenda for the New Congress
186. State and Federal Securities Market Regulation
187. The SEC's Concern with Short Selling
188. Glass Steagall, Tying and Conflicts of Interest
189. The Registration of Mortgage-Backed Securities of Fannie Mae and Freddie Mac
190. Access by Institutional Investors to Foreign Electronic Trading Venues
191. The European Union's Financial Conglomerate Directive
192. [Missing]
193. The Latest Revisions to Basel II and Implementation Plans in the United States
194. Removal of Archaic Bank Regulatory Restrictions
195. Predatory Lending and Federal Preemption of State Laws
196. Legislation on Fannie Mae and Freddie Mac
197. The Responsibilities of Financial Professionals and Firms in Recent Financial Scandals
198. Taxpayer Exposure to Liabilities of the Pension Benefit Guarantee Corporation
199. SEC Proposals for More Shareholder Democracy
200. Mutual Fund Expenses and Soft Dollars
201. New York Stock Exchange Governance and Market Structure Issues
202. Simple Proposal to Deal with Market Timing and After-Hours Trading
203. Toward a Single Transatlantic Market in Financial Services
204. Enabling Institutional Investors to Play a More Effective Role in Corporate Governance
205. Regulation NMS and Securities Market Structure
206. Prohibition of Directed Brokerage and Other Abuses by Investment Management Companies
207. The Possible Extension of the Terrorism Risk Insurance Act
208. The Pressing Need for Corporate Pension Reform
209. International Accounting Standards
210. The SEC's Proposal for Regulating Hedge Funds
211. The Insurance Brokerage Scandal
212. The Financial Services Agenda for the Second Bush Administration
213. The Impending Crisis in Defined Benefit Pensions
214. Expanded FDIC Examination Authority
215. Sunset the PCAOB
216. Proposed Legislation to Regulate the GSEs
217. Regulation NMS
218. Limiting GSE Portfolios
219. Evaluating Section 404 of the Sarbanes-Oxley Act Concerning Internal Controls
220. Deposit Insurance Legislation
221. The Federal Housing Enterprise Regulatory Reform Act of 2005 (S. 190)
222. Open Letter to SEC Chairman Christopher Cox
223. Whatever Becomes of Basel II, Prompt Corrective Action and the Leverage Ratios Should Be Preserved

224. Wal-Mart's Pending Application to Acquire an Industrial Loan Company
225. SEC Adoption of Communications Advances
226. FDIC Replenishing of the Deposit Insurance Fund
227. Margin Regulations
228. The Disclosure of Soft Dollars by Investment Advisors
229. Open Letter to Federal Reserve Chairman Ben S. Bernanke
230. Federal Preemption for Financial Services Firms
231. Welcome Actions by the Securities and Exchange Commission
232. Strengthening the Capital Structure of Federal Home Loan Banks
233. The FDIC's Proposed Risk-Based Assessment System
234. Enhancing Competition in the Sale of Stock Market Data
235. Risks of Bank Concentration in Commercial Real Estate Lending
236. A Financial Agenda for the New Congress
237. Shareholder Access to Director Elections
238. Basel II: One-and-a-Half Cheers for the Standardized Approach
239. Facilitating Bank Failure Resolution
240. The Proposed Merger of Principal U.S. Futures Exchanges
241. The FDIC's ILC Moratorium
242. The Competitiveness of U.S. Securities Markets
243. The SEC's Proposed Prohibition of Notching
244. The Usefulness of Hedge Fund Post-Mortems
245. Subprime Mortgage Lending Remedies and Concerns
246. Allowing U.S. and EU Corporations to Adopt U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS)
247. Limitations on Auditors' Liability
248. Lessons for Basel II from the Recent Financial Turmoil
249. Financial Turmoil and Implications for Mortgages and Related Mortgage Securities
250. Treasury Department's Mortgage Foreclosure Program
251. Government-Sponsored Enterprises
252. Doubts About the Master Liquidity Enhancement Conduit (MLEC)
253. Would Basel II Have Helped Prevent the Subprime Turmoil?
254. Facilitating FDIC Bank Failure Resolution
255. Facilitating Mortgage Renegotiations: The Policy Issues
256. Industrial Loan Company (ILC) Legislation
257. [Missing]
258. If Bear Had Been a Bank
259. Mortgage Delinquencies and Foreclosures
260. Reducing Inappropriate Political Pressure on the Federal Reserve
261. Regulation of Short Selling
262. The Future of the Government-Sponsored Enterprises
263. The Regulation of Investment Banking

264. An Open Letter to President-Elect Obama
265. Regulation of Credit Rating Organizations
266. Fair Value Accounting
267. Regulatory Responses to the Current Crisis Have Undermined the Integrity of Tier 1 Capital and Tier 1 Capital Requirements
268. The Need for More Transparency in Discretionary Financial Rescue Programs
269. Restructuring Financial Regulation
270. Bank Bailouts and Borrower Bailouts
271. Monitoring Systemic Risk
272. Refocusing Financial Rescue Plans
273. Regulation of Financial Reporting
274. Reinstatement of Short-Sale Restrictions
275. Strengthening the Resiliency of Money Market Mutual Funds
276. Regulatory Initiatives of the Securities and Exchange Commission
277. Reducing Interference with Accounting Standards and Devising Securities to Price Moral Hazard
278. A New Consumer Financial Protection Agency
279. Audit of the Federal Open Market Committee Decisions
280. Reforming the Primary Dealer Structure
281. The Resolution of Large, Complex Financial Institutions
282. The Importance of Addressing the Subsidization of Housing GSEs in Financial Reform Legislation
283. Regulation of Executive Compensation
284. Proposed Tax on Large Banks Is Poorly Designed and Premature
285. Improving the Transparency of the Cost of Policies That Expand the Financial Safety Net
286. Resolution Regime for Troubled Financial Institutions
287. The Equity Markets: One Size Does Not Fit All
288. Transparency in Federal Reserve Emergency Financial Rescue Programs
289. Resolving Systemically Important, International Financial Institutions
290. Strengthening Transparency and Global Reporting Convergence
291. The FDIC's Proposal for Setting Insurance Premia of Large Banks
292. Resolution and Bailout of Large Complex Financial Institutions
293. Derivatives, Clearing and Exchange-Trading
294. Mortgage-Backed Securities in the Federal Reserve's Portfolio
295. Group of Governors and Heads of Supervision Statement on Capital Standards
296. Missed Opportunities in the Dodd-Frank Act
297. Proxy Access and the Market for Corporate Control
298. The Monumental Task Assigned to the Fed
299. Regulation of Broker-Dealers and the Dodd-Frank Act
300. Principles to Guide the Implementation of the Orderly Liquidation Authority Called for Under the Dodd-Frank Act
301. Federal Reserve Lending Programs
302. Stress Testing the Fed

303. The Case for a Properly Structured Contingent Capital Requirement
304. Beyond Dodd-Frank
305. Proposed Interagency Rule on Executive Compensation
306. Recent Financial Stability Oversight Council's Reports on Risk Retention and Proprietary Trading
307. Qualms About the Basel III Approach to Bank Capital Requirements
308. Comment on the Treasury's White Paper: Reforming the Housing Finance Market
309. Systemic Risk and Money Market Mutual Funds
310. The Crises in State and Municipal Pension Funds
311. Risk-Retention in the Dodd-Frank Act
312. Some Concerns About the FDIC and Federal Reserve System Proposed Rule on Resolution Planning
313. The FDIC and Unintended Consequences of Dodd-Frank
314. Reforming Credit Rating Organizations Under Dodd-Frank
315. Financial Asset Impairment Reserves
316. Improving the Regulatory Process and Financial Cost-Benefit Analysis
317. The Basel Proposed Rules on Liquidity Regulation and a Suggestion for a Better Approach
318. MF Global and the Implications for the Primary Dealer Structure
319. The Financial Stability Board's Methods for Defining Globally Systemic International Banks
320. A Regulatory Blueprint for Mismanaging the Sovereign Debt Crisis
321. Creating a More Flexible and Accountable Basel System
322. The Federal Reserve Board Proposal for Enhanced Prudential Standards and Early Remediation Requirements
323. Alternatives to the Proposed Risk-Based Bank Capital Standards
324. Some Lessons from the MF Global Debacle
325. Regulation of Money Market Funds and Systemic Risk
326. The Volcker Rule: Market Making Exception
327. Treasury Mismeasurement of the Costs of Federal Financial Stability Programs
328. Two Cheers for the JOBS Act
329. Financial Stability and the Regulation of Money Market Mutual Funds
330. LIBOR Reform
331. Specialized Corporate Disclosure Provisions in the Dodd-Frank Act
332. Regulation of Bank Capital and Liquidity
333. An Open Letter to President Obama
334. Glass-Steagall and the Volcker Rule
335. Improving Capital Adequacy Disclosure
336. How Can We Do Better Than the Basel Liquidity Coverage Ratio?
337. Caveat Creditor: Qualified Mortgage Rules Fail to Protect Borrowers or the Economy
338. Lessons from Cyprus
339. Restricting Access to Regulatory Data
340. The Dangers of Substituting Foreign Compliance for US Supervision of Financial Derivatives Activity
341. Questions About Brown-Vitter
342. Money Market Funds—A Solution?

343. Making Bank Capital Requirements Simpler, More Comparable, and More Transparent
344. The New Qualified Residential Mortgage Rule Proposal
345. Beating Bad Trades
346. Liquidity Ratios: The Basel Committee, US Regulators, and the International Shadow Committees
347. Asset Management and Systemic Risk
348. The J.P. Morgan Settlement
349. Data Breaches and Payment System Risks
350. Regulating to Beat the Clock: The Final Implementation of the Volcker Rule
351. The Arms Race Between Innovation and Regulation in Derivatives Markets
352. Limiting Systemic Risk and Too Big to Fail
353. Revisiting Equity Market Structure: Principles to Promote Efficiency and Fairness
354. An Open Letter to the Incoming Congress
355. The New York Fed and Primary Dealers
356. Releasing Data: Promoting Efficiency or Fairness
357. The Fed's SIFI's Surcharge: An Alternative Proposal
358. Regulating Cross-Border Swaps Transactions of US Banking Affiliates
359. Executive Compensation, Clawbacks, and Accounting Restatements
360. Strengthening Stress Tests
361. TLAC: The Last Nail in the Coffin of Too Big to Fail?
362. Deposit Insurance, Government Guarantees, and Too Big To Fail: What Remains to Be Done?

Statements of Joint Meetings

1. Improving the Basel Committee's New Capital Adequacy Framework: New York, US, June 14, 1999
2. Reform of Bank Regulation and Its Application to Japan: Tokyo, Japan, October 16, 2000
3. Reforming Bank Capital Regulation: Amsterdam, the Netherlands, June 18, 2001
4. Reforms in the Progress of Restructuring International Sovereign Debt: Washington, DC, US, October 7, 2002
5. Enhancing International Financial Market Integration: Washington, DC, US, November 15, 2004
6. Aging and Pensions: A Ticking Bomb: Seoul, Korea, October 31, 2005
7. Lessons from Recent Financial Turmoil: Copenhagen, Denmark, September 10, 2007
8. [Unnamed]: Santiago, Chile, August 17, 2009
9. The World in Crisis: Insights from Six Shadow Committees: Washington, DC, US, November 19, 2012
10. Misdiagnosis of Crisis Has Led to Botched Liquidity Regulation: Tokyo, Japan, October 28, 2013

About the Author

Robert Litan is a lawyer and economist who has had a four-decade-long career in legal practice, as a leading economic analyst and think tank executive, as a foundation executive, as an executive in the media business, and in high-level appointed positions in the federal government. He has written extensively in books, professional journals, and popular publications on a wide range of economic subjects, including finance and financial reform. He is currently an adjunct senior fellow at the Council on Foreign Relations and a partner at the Korein Tillery law firm based in St. Louis and Chicago. He served for many years as a member and co-chairman of the Shadow Financial Regulatory Committee.