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Statement of the Shadow Financial Regulatory Committee on

The Regulation of Investment Banking

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The Shadow Committee congratulates federal policy makers for not providing direct financial support to assist in the resolution of Lehman Brothers. Nonetheless, the federal government's financial assistance extended to J.P. Morgan's rescue of Bear Stearns last March, coupled with the opening of the Fed's discount window to primary dealers, has generated a widespread view that regulation and supervision of investment banking (whether conducted by a standalone investment bank or within a financial holding company) must be augmented and that the Federal Reserve, as the source of liquidity, should oversee this effort.

The Committee recognizes the attractiveness of subjecting investment banking to enhanced prudential regulation if investment banking activities continue to be protected through access to the Fed's discount window. In addition, the Committee acknowledges, as Fed Chairman Ben Bernanke recently argued at the annual Jackson Hole conference, that large failed investment banks pose two serious challenges to the financial system. There is a risk of contagion if the many counter-parties to failed investment banks are not paid. In addition, the current bankruptcy process may be ill-suited for resolving complex financial institutions in a timely fashion.

Not surprisingly, under these circumstances, regulators and many others believe it is necessary for the Federal Reserve to offer discount window loans, or in a last resort, assist rescues of large troubled financial institutions' investment banking operations (or, as in the LTCM case, serve as the host for a meeting of private actors to rescue a large, unregulated hedge fund). In particular, there is a widespread concern that without such intervention, institutions facing these uncertainties would have strong incentives to dump even high-quality assets on the market, triggering a broad financial panic.

The Committee believes it is important, however, not to rush to judgment on the need for intervention in many cases, or on the inevitability of tightened Fed regulation of investment banking. In fact, there are costs both of Fed intervention and more restrictive regulation that are essential to recognize.

The knowledge that the Federal Reserve can and will effectively bail out creditors by discount window lending entails two types of costs. Creditors of financial institutions with perceived guaranteed access to the discount window have less incentive to monitor and prevent excessive risk-taking by managers of these organizations. This exposes taxpayers to potential losses if the institutions run into financial trouble and are merged, with federal assistance, with other institutions (as in the case of Bear Stearns). In addition, if potential acquirers of troubled financial institutions know that the federal government will protect them against loss, they have leverage in their negotiations and have incentives to postpone or reduce their bidding strategically.

The Committee believes that future policy in this area should be driven by three goals: (1) to dramatically reduce the systemic threats posed by investment banking activities; (2) to significantly reduce the risk of Fed assistance where it is not necessary; and (3) to significantly reduce taxpayer exposure to loss in the much less likely event of appropriate Fed intervention.

To reduce systemic risk, the Committee strongly supports the efforts of the Federal Reserve Bank of New York to encourage the formation of a central clearinghouse for credit default swaps and perhaps other derivatives. A clearinghouse has three important virtues that would significantly reduce systemic risk posed by investment banks dealing in these instruments. A clearinghouse can net positions. Counter-parties are paid by a clearinghouse and do not need to look to the failed institution for payment. And a clearinghouse can establish rules to assess members to share losses in the event that a counterparty does fail.

To reduce the likelihood of unnecessary Fed intervention, the Committee urges the Congress to require joint agency decision-making for federal assistance extended as part of the resolution of any financial institution with investment banking activities and to require other similarly situated financial institutions to play a role in funding such assistance. Congress already has imposed such a process under the Federal Deposit Insurance Corporation Improvement Act for any protection granted by the FDIC to uninsured depositors and creditors. In the latter case, federal protection may be provided only on a two-thirds vote of the Boards of the Federal Reserve System and the FDIC, and approval by the Treasury Secretary in consultation with the President. This mechanism allows commercial banks to have a stake in the extension of federal assistance. Under FDICIA, commercial banks bear the losses of such interventions, and thus have strong incentives to provide political support for FDIC protection of uninsured claims only when systemic risk warrants it. A similar process should be adopted for institutions with investment banking activities, together with the loss-sharing mechanism we describe next.

The Committee urges the Fed, the SEC, and the financial industry to develop innovative ways to have market participants who benefit from Fed intervention share some of the losses that taxpayers otherwise would bear when the federal government guarantees some or all of investment-banking related losses (as part of a forced rescue, reorganization or liquidation). In effect, as just described, this would mirror what has been true since the adoption of FDICIA when a decision is made to protect the uninsured depositors and creditors of a large commercial bank. We envision a similar loss sharing mechanism for financial institutions with investment banking liabilities, who because of their significant financial exposures to other such institutions clearly benefit when the federal government picks up the tab for investment banking losses. Accordingly, the Committee urges the relevant members of the financial industry to work with federal authorities to develop such a plan, and for Congress to implement it through legislation if necessary. This loss sharing would bring the wisdom and discipline of market consensus about appropriate federal intervention when decision-makers are confronted with the failure of institutions involved in investment banking.

Interestingly, the financial industry has just moved in this direction. Over this past weekend, ten financial institutions agreed to establish a $70 billion liquidity facility to protect each of the participants against future market turbulence. This illustrates that large financial institutions recognize the advantages of mutual protection and loss-sharing in the face of systemic risk.

In addition, policy makers are calling for a special system for resolving insolvent financial institutions with investment banking activities, analogous to the process the FDIC now has for troubled commercial banks. Such a process could be necessary if the collapse of these other types of institutions creates financial instability. The experience with the Lehman bankruptcy should shed light on whether a special resolution mechanism for failed financial institutions with investment banking operations is appropriate.

Finally, there are also dangers associated with augmented Fed regulation of investment banking activities. While recent events clearly have proven the need for greater risk management throughout the investment banking industry (which a recent industry report itself recognizes), imposing a rigid safety and soundness regulatory regime suitable for commercial banking activities on investment banking operations (including those of standalone investment banks) runs a real risk of curtailing the development of new socially valuable financial instruments and strategies. Indeed, standalone investment banks have been particularly well known for their abilities to innovate in this way. There is also a risk that, over time, augmented Fed regulation, however well intentioned, would simply drive financial innovation off-shore.