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Statement of the Shadow Financial Regulatory Committee on

The Need for More Transparency in Discretionary Financial Rescue Programs

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In the midst of the current financial crisis, the U.S. has experienced numerous specific changes in regulatory rules and procedures and seen a proliferation of ad hoc and non-transparent programs. These actions have dramatically expanded the bounds of agency discretion and government control of financial institutions. Many members of the press and financial industry applauded agency heads for their creativity in acting promptly and forcefully to address emerging problems, despite the absence of evidence of the likely impacts of the policies adopted.

To assess the effectiveness of any program and to establish accountability for any adverse consequences requires a clear articulation of regulatory intent and program mechanics. This information is needed before government officials and affected parties can determine the extent to which likely benefits exceed program costs and the programs are in fact achieving their goals.

Policymakers must always balance benefits and costs across different time frames and different sectors of the economy. Whatever short-run benefits policy innovations might provide to the financial sector, in the aggregate recent programs impose large long-run burdens on taxpayers. They also generate adverse incentives that promise to expand future risk taking by financial institutions and to reduce the efficiency of financial markets.

Two recent interventions illustrate the dangers inherent in non-transparent extension of regulatory scope and discretion: a) an FDIC proposal to modify its rules on the deposit interest rates that less than Well Capitalized institutions may offer and b) innovative lending and asset purchase programs adopted by the Federal Reserve.

FDIC's Proposed Rules to Relax Deposit Rate Restrictions on Less Than Well Capitalized Institutions

The Federal Deposit Improvement Act of 1991 requires regulators to classify institutions as Well Capitalized, Adequately Capitalized, or Undercapitalized. On January 27, 2009 the FDIC proposed a modification in its rules restricting the deposit interest rates that institutions classified as less than Well Capitalized are permitted to pay. The proposed rule has three elements, one of which was left implicit. Under the new proposal, less than Well Capitalized institutions would be allowed to pay rates as high as 75 basis points over a designated benchmark rate. The FDIC explicitly specified the 75 basis point differential and how the benchmark rate would be defined. Left implicit was how the FDIC would determine whether to grant a less than Well Capitalized institution a waiver to solicit brokered deposits. This determination is especially important because 75 basis points represents a substantial return when short-term interest rates on federal funds and Treasury securities are approaching zero.

Until the criteria the FDIC will use to determine which institutions would and would not receive waivers, the rule is incomplete and subject to potential misuse. For example, the FDIC has a practical limit on the number of institutions whose insolvency can be resolved within a given week or month. Whenever the number of banks in the less than Well Capitalized category increases sharply, the FDIC might be sorely tempted as a way to manage its caseload to grant more and more waivers to buy time by permitting troubled institutions to attract insured deposits from healthy competitors. The lack of explicit and transparent criteria for granting waivers will only increase that temptation and result in an increase in *de facto* forbearance.

Asset Acquisition Programs of the Federal Reserve

In response to the financial crisis, the Federal Reserve has created and continues to expand the range of collateralized lending and asset purchase facilities it operates. Its traditional facilities only accepted Treasury obligations (and occasionally GSE debt and bankers acceptances). Accepting large amounts of private debt exposes the Federal Reserve to substantial credit risk and threatens to transfer wealth ultimately from the taxpayer to the users of these new and creative facilities. The size of the potential losses depends upon the changes in the value of the underlying collateral and the structure and terms and conditions of each program. To be held accountable for program design *ex ante*, the Federal Reserve should disclose such matters as the identity of their counterparties, how the arrangements are priced, the quality and extent of collateralization, and any put-back options the Fed may hold. To make itself accountable *ex post*, the Federal Reserve should report at frequent intervals the mark-to-market returns on these programs. The evidence on the $29 billion portfolio it acquired as part of its support of the Bear Stearns acquisition by JPMorgan Chase illustrates the risks that such programs may entail. The Federal Reserve now indicates that this portfolio is over $4 billion underwater. This has occurred despite initial claims that the portfolio was of investment grade. To preserve both its reputation and its political independence, the Federal Reserve needs to be especially scrupulous in setting up and administering broad-based programs that transfer risk and threaten to redistribute wealth.