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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

Edward J. Kane
520.299.5066

George G. Kaufman
312.915.7075

Christian Leuz
773.834.1996

Statement of the Shadow Financial Regulatory Committee on

Reducing Interference with Accounting Standards and Devising Securities to Price Moral Hazard

September 14, 2009

Throughout the financial crisis, the two major accounting standard setters—the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)—have been under strong pressure to account for and accommodate concerns of financial regulators about financial stability and procyclicality in the design of the accounting rules. The Committee is concerned about these pressures as they lead to increasing interference with independent accounting standard setting and the purpose of financial reporting. In the Committee's view, it is preferable to separate accounting standard setting and financial reporting from measuring regulatory capital for financial institutions. Accounting standards and regulatory standards have different objectives and goals. Accounting standards serve the informational and contractual needs of investors in all public companies. Regulatory standards apply to financial institutions and are aimed at ensuring the safety and soundness of the financial system. At times, these two objectives may be in conflict. This conflict is most evident in the measurement of a firm's capital in a crisis. During these times, financial regulators may be inclined to be more lenient with loan loss provisions or writeoffs while investors may prefer timely loss recognition.

Capital is the difference between the value of a firm's assets and the value of its liabilities. In defining these values, GAAP and IFRS provide a useful and independent starting point for the measurement of the elements that can be used to define regulatory capital. This separates the baseline measurement of a firm's assets and liabilities from the incentive conflicts that financial regulators face. Specifically, independent measurement makes it more difficult to exercise regulatory forbearance through the manipulation of a financial institution's asset values.

However, this does not preclude regulators from using elements in the financial statements to define regulatory capital differently from GAAP equity capital and to set capital requirements that are deemed necessary for prudential purposes. Many such adjustments exist. For example, for the purpose of calculating regulatory capital, U.S. bank regulators adjust a bank's equity capital as reported under GAAP for unrealized losses and gains on available-for-sale debt securities to obtain Tier 1 capital.

Separating accounting standards and regulatory capital requirements would have several principal advantages. First, it does not compromise financial accounting for investors. Second, it makes regulators' deviations from GAAP transparent and hence regulators accountable for explaining these deviations for regulatory capital purposes. Third, it permits regulators in individual countries to tailor their definitions of regulatory capital and capital adequacy to the needs of their financial system without interfering with accounting standard setting. This in turn would make the convergence of international accounting standards less political and contentious.

These aforementioned principles are particularly important in light of the fact that the G20, the Financial Stability Board and various prudential regulators have made capital requirements the centerpiece of their blueprints for regulatory reform. The effectiveness of capital requirements depends crucially on the proper valuation of assets and liabilities, including timely impairments. But reliable valuations are hard to come by when markets are in turmoil.

The "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" issued by the U.S. Treasury on September 3, 2009 therefore recognizes the need to augment capital requirements with supplementary triggers for regulatory action. This Committee has steadfastly urged the use of subordinated debt as a supplementary trigger and as a source of contingent capital. The Committee continues to believe that large banks should be required to issue uninsured subordinated debt, and that regulators should be required to respond to substantial declines in the price of this debt.

However, the large number of bailouts of and the guarantees to large financial institutions in recent months, which protected subordinated creditors against losses, have undermined the credibility of a simple subordinated debt instrument as a source of market discipline and weakened its informativeness as a trigger for regulatory action. In light of these developments, we propose to two new securities that include government interventions as triggers. Such securities would put a market price on moral hazard and regulatory forbearance.

One suggestion is for the Treasury to create a prediction market for bailouts of financial institutions. Prediction markets have performed well in the context of political elections and have been used by private firms internally for forecasting purposes. The "Failure Prediction Contract" (FPC) would be issued for individual large financial institutions, perhaps in proportion to their capital, and sold by the Treasury. It would pay out a pre-specified amount to investors in the event a bank fails, is bailed out or taken over by the government or the regulator, or receives any form of emergency credit support. The creation of such contracts would create incentives for financial regulators to enforce capital requirements in the first place.

An alternative suggestion is to require large financial institutions to issue a bond that does not have to be repaid in the event a bank fails, is bailed out or taken over by the government or the regulator, or receives any form of emergency credit support. This security is analogous to a catastrophe bond, except that its trigger event is bank failure or government intervention. Such a security would have the added benefit of absorbing losses in times of crisis.