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SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 354

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An Open Letter to the Incoming Congress

December 8, 2014

Socrates warns that the worst kind of deception is self-deception. It is wishful thinking to suppose that rulemakings guided by the Dodd-Frank Act (DFA), G-20 protocols, and the Basel Committee on Banking Supervision can develop an adequate response to the extensive rent-seeking and supervisory breakdowns that set the stage for the Great Financial Crisis.

The danger of new financial crises remain high for two reasons: because risk-taking in complex financial companies and derivatives markets is becoming less rather than more transparent and because the organizational cultures of financial institutions and their regulators remain deeply flawed. At megafirms, incentive structures support a climate in which managers cover up and deny the extent to which aggressive risk-taking extracts subsidies from taxpayers through the financial safety net and incentive conflicts in government agencies (including the revolving door) make top regulators reluctant to challenge the deception. Safety-net subsidies encourage innovations designed to make risk taking hard to monitor. They also encourage efforts to make their organizations politically, administratively, and economically difficult for government officials to regulate or unwind failing institutions.

The DFA and subsequent rulemakings increased regulators' authority over financial institutions, but have not addressed practical difficulties regulators face in exercising that authority, particularly in times of economic stress. It is clear that sharply increasing effective capital ratios for institutions that are difficult to regulate or unwind would improve incentive structures. But the Shadow Committee believes that complex definitions of loss-absorbing capital surfacing in proposed capital standards will encourage counterproductive regulatory arbitrage.

Much of the complexity in these standards traces to differences in the ways that the US and other tax codes treat dividends on stock as opposed to interest payments on forms of hybrid debt such as contingent capital and subordinated debt. The Shadow Committee urges Congress to encourage the simplification of capital requirements. It can reinforce efforts to define regulatory capital at institutions protected by the government safety net as the sum of stockholder equity and forms of hybrid debt by taxing income from both instruments in exactly the same way. This can be established either by making dividends on bank holding company stock tax-deductible or by eliminating the deductibility of interest on subordinated debt. In the US, the first approach would lower the cost of equity; the second would equalize the cost of subordinated debt and contingent capital obligations. Either could be done in a tax-neutral way as part of corporate tax reform packages.

A second issue that the Shadow Committee has repeatedly stressed is the need for Congress to redefine the federal government's role in housing finance. We urge Congress to work with the Administration to end the conservatorships of Fannie Mae and Freddie Mac and to make the costs of federal homeownership and homebuilding programs observable to ordinary citizens. Fluctuations in housing activity and prices would become less intense if Congress were to transform its longstanding below-the-radar, off-budget efforts to promote housing by subsidizing mortgage loans for all customers into direct and explicit subsidies to specific classes of recipients (such as low-income homeowners) at known costs that would be subject to regular budget review. This would allow detailed decisions about mortgage terms and availability to be handled apolitically in the private sector.