SHADOW FINANCIAL REGULATORY COMMITTEE

COMMITTEE MEMBERS

GEORGE G. KAUFMAN
Co-Chair
Loyola University Chicago

RICHARD J. HERRING
Co-Chair
University of Pennsylvania

RAY BALL
University of Chicago

MARSHALL E. BLUME
University of Pennsylvania

CHARLES W. CALOMIRIS
Columbia University

KENNETH W. DAM
University of Chicago Law School

ROBERT A. EISENBEIS
Cumberland Advisors

EDWARD J. KANE
Boston College

CHRISTIAN LEUZ
University of Chicago

ROBERT E. LITAN
Brookings Institution and Kauffman Foundation

KENNETH E. SCOTT
Stanford Law School

CHESTER SPATT
Carnegie Mellon University

PETER J. WALLISON
American Enterprise Institute

An independent committee sponsored by the American Enterprise Institute

http://www.aei.org

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

Statement No. 269

For Information Contact:

Marshall E. Blume
215.898.7616

George G. Kaufman
312.915.7075

Peter J. Wallison
202.862.5864

Statement of the Shadow Financial Regulatory Committee on

Restructuring Financial Regulation

February 9, 2009

The ongoing financial crisis provides lessons that should be used to guide the redesign of our regulatory system. Recent proposals such as those of the Group of Thirty and the Congressional Oversight Panel do not appear to have recognized these lessons.

The government’s response to the weakening and failure of large financial institutions has been ad hoc and inconsistent. The Treasury and Federal Reserve decided to rescue Bear Stearns through a buyout by JPMorgan Chase; the negotiations were hurried and not well thought out. At the last moment, JPMorgan Chase had to raise its equity offer. Then, six months later, Lehman Brothers—an institution larger than Bear Stearns—was allowed to fail, raising uncertainty about both the true condition and the future treatment of other large investment and commercial banks. Within a few days, AIG was effectively nationalized and subsequently required unanticipated serial injections of capital.

These hasty and ill-considered actions teach us that inconsistent government action has a high price. The rescue of Bear Stearns encouraged Lehman and other large investment banks to believe that they would be protected by the government and would not need to sell assets or raise substantial new capital. The government’s refusal to rescue Lehman came as a

shock to these institutions and to the market as a whole. Immediately thereafter, Merrill Lynch had to negotiate a hasty purchase by Bank of America, and both Morgan Stanley and Goldman Sachs transformed themselves into bank holding companies to obtain more assured access to Federal Reserve funding. Clearly, the government's failure to articulate a clear and comprehensible policy on its rescue plans created a form of moral hazard; the managements of weakened and unstable institutions concluded that they could avoid raising the capital that prudence required.

The government's policies are still not fully explained. It initially sought $700 billion to buy troubled assets from banks, and then abandoned that objective. It embarked upon a program of providing additional capital to banks, and then abruptly decided to guarantee a portion of the assets of Citibank and Bank of America. With each of these moves, the expectations of private parties were disappointed, with losses caused by this change in government plans. This is not a way to attract private capital. With the change of administrations, it seems likely that the government will go back to purchasing assets, or maybe insuring them, or perhaps something else. Meanwhile, the government's rescue plans have focused on making the large banks even larger, despite the additional moral hazard that arises when an institution is perceived as too big to fail.

The commercial banks also failed to prepare themselves sufficiently by raising additional capital. The banks' regulators did not understand the severity of the losses the banks would incur, and acceded to the natural desire of managements not to dilute their shareholders by seeking new equity capital when their stock prices had fallen substantially. Many institutions raised some new equity, but not enough to strengthen their capital ratios or to prepare them for what was to come.

It was apparently difficult for regulators to evaluate the risk of the assets held by the institutions they were supervising. Many of these assets were new and complex, with little historical performance data available. Some banking organizations created off-balance sheet entities, such as structured investment vehicles, or SIVs, which were largely ignored by regulators, even though they created reputational risks. Too late, the regulators forced banking organizations to cover the losses in these off-balance-sheet entities. These failures suggest that regulators need help in recognizing and acting to suppress risk-taking and other imprudent actions. Because future risks are unlikely to replicate current problems, it is apparent that regulators need signals to alert them to unwarranted and excessive risk.

The inability of the regulators to recognize and deal with increasing risk was compounded by the procyclicality of the capital requirements. When the market values are rising, bank capital also rises, encouraging banks to borrow more in order to maintain their debt to equity ratios. When asset prices decline, bank leverage increases and banks confront both the difficulty of selling assets to reduce leverage and borrowing the necessary funds to continue to carry the assets they cannot sell at what they consider a price commensurate with the assets' value.

The recent reports of the Group of Thirty and the Congressional Oversight Panel—two recently published views of how regulation should be reformed—reflect very little awareness of these lessons. They both assume that the need for extending regulation to

currently unregulated sectors of the economy is self-evident, even though it has clearly failed in the case of commercial banks. Neither report tries to explain the function of bank regulation, why bank regulation failed, and what corrective measures are necessary. Although both reports recognize the importance of addressing the pro-cyclicality of regulation, they leave the necessary actions in the hands of the regulators. This is of a piece with the central flaw of these reports: the notion that enhanced regulation and enhanced authority for regulators will prevent future financial turmoil or crisis. The failure of bank regulation tells us that regulation is no panacea. For whatever reason, perhaps because they are subject to procyclical political pressure from Congress, regulators have difficulties taking unpopular countercyclical actions. To insulate regulators from these pressures, the Shadow Committee recommends that countercyclical measures, such as imposing increased capital requirements when asset prices and profits are rising, be mandated by a statutory formula and not left to regulatory discretion. The formula should be applicable to all regulated banks that reach a certain size, not just those that are deemed systemically significant by a regulator of systemic risk.

Beyond the recognition of the procyclicality problem, neither report sufficiently recognizes the problem of moral hazard. In fact, both reports recommend the prudential regulation and supervision of "systemically significant" financial institutions, including securities firms, insurance companies, hedge funds and other financial institutions, in addition to banks. Apart from the problem of defining what is a systemically significant institution, this approach is a troubling source of moral hazard. Any company that is designated as systemically significant and specially regulated for that reason will immediately be seen by the markets as too big to fail. As a result, this and other similarly designated companies will have less difficulty than their competitors in raising capital and obtaining credit. Lower interest rates and capital costs will eventually allow such companies to dominate their markets. In light of the problems caused by Fannie Mae and Freddie Mac, it is curious that these reports would both recommend expanding the number of companies that would also be implicitly backed by the government. There is no reason why the taxpayers should be called upon to protect the large creditors of any financial institutions against loss, but if government policy continues to create institutions that are deemed too big to fail that will be the inevitable outcome.

The reports also did not recognize that the bank regulators seriously underestimated the need for capital during the early stages of the current crisis, when it was still relatively easy for the banks and others to raise capital. This is another example of regulatory failure, and another reason why regulatory discretion must be curbed, not enhanced. The Shadow Committee believes that the capital levels that would qualify a bank as well capitalized should be raised substantially in normal market conditions, and gradually reduced during times of market stress. This permits capital to play its principal role as a cushion against losses.

It is also clear that bank regulators have limited abilities to see and understand the risks that build up in the banking system. Neither report recognizes this problem or proposes any substantial change in regulation to deal with it. Smart regulation would enlist market discipline in controlling risk taking. For example, the Shadow Committee has recommended (Statement No. 264, December 8, 2008, "An Open Letter to President Obama") that regulators be directed to develop metrics or indicators of risk-taking that

banks should be required to publish regularly, so the markets can make a better informed decision concerning the risks that the banks are assuming. In 2000, the Committee also recommended that large banks issue subordinated debt that cannot by law be bailed out (Statement No. 160, March 2, 2000, "Reforming Bank Capital Regulation"). A rise in the interest rate on these securities over a benchmark would be an indicator for the regulators that the market perceives that a particular bank is taking excessive risk. The Committee continues to believe that large banks should be required to issue uninsured subordinated debt, and that the regulators should be required to respond publicly to substantial interest rate changes on this debt and to increases in the spread on credit default swaps. Consideration should also be given to establishing a predetermined macro signal, such as a rapid increase in the growth rate of aggregate loans, that would trigger a requirement for an increased capital ratio.

Any financial crisis provides an opportunity to locate and address the weaknesses in financial architecture that allowed banks and other financial institutions to require government rescue or to fail. It should not be viewed as an opening to adopt questionable ideas, such as extending the scope of safety-and-soundness regulation beyond commercial banks.