



Economic Policies  
for the 21st Century

# Financial Regulatory Reform: Some Key Issues

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# Systemic risk

- What does the systemic risk agency do? Does it watch for regulatory gaps and blow a whistle? Or order action over the wishes of the direct supervisor?
- Only the Fed has the broad view of the economy needed to assess systemic risk. A Council could be harmful if it hinders the Fed.
  - The FDIC focuses on the deposit insurance fund and not on the overall financial system or economy.
- All banking supervisors made mistakes in the lead-up to this crisis, including:
  - Fed: umbrella regulator for bank holding companies.
  - FDIC: condition of the deposit insurance fund in part reflects the difficulty of taking prompt corrective action to avoid losses being borne by the fund.
  - OTS: Office of Thrift Supervision. AIG, IndyMac, WAMU. Legislation will appropriately fold OTS into OCC; there is no longer a need for a separate charter for banks that specialize in mortgage lending.
  - OCC: Office of the Comptroller of the Currency
  - State banking and insurance departments
- Does the Fed need to supervise banks?
  - Debatable, but we should want the Fed involved: only the Fed has the broad view and the technical capability to appreciate the relationship between large banks and the overall economy.
  - Yes, that can mean regulatory capture, but the alternative is worse.

# Non-bank resolution

- The Frank-Dodd-Geithner proposal is a permanent & supercharged TARP.
  - Permanent TARP: executive branch can deploy taxpayer money without a vote
  - Supercharged: Ability to change contracts and allocate a failed firm's resources with complete discretion (despite the veneer of certainty).
- Key questions to ask of the proposal:
  - Who is in charge? Executive branch or the judiciary?
  - Who decides to spend money? Executive branch or Congress?
  - What is the mission? Protect the taxpayer? Stabilize the financial system?
- We have seen the abuse of broad authority spend money and (effectively) change contracts in the auto bankruptcies. Examples include:
  - Spending money: taxpayer funds were transferred from the TARP to the UAW's health care funds without a vote of Congress
  - Changing contracts: junior creditors (unions) were favored over senior creditors.
  - Who decides how to split up a failing firm? A judge, or Administration officials?
    - Bankruptcy judge said ok to the questionable auto bankruptcy because the government was putting in money (and because the judge was unwilling to countenance massive job losses).

# Bankruptcy as an alternative

- The bankruptcy process gives more certainty (for example, no bailout without a difficult vote of Congress), due process, and better exclusion of political involvement. Providing certainty at the end will change behavior up front and help avoid future crises.
  - The House and Senate bills have the veneer of certainty in following the FDICIA resolution process, but in the end there is complete discretion for the executive branch.
  - In bankruptcy, a judge decides on resource allocation instead of Treasury, FDIC, or White House political operatives.
- Congress must approve spending taxpayer funds; there is no automatic TARP-like authority.
  - This is different from resolution of failed banks where there is an explicit government safety net on deposits and a well-understood path for resolving failed banks. The FDIC process broke down with larger institutions such as WAMU and IndyMac.
- Can bankruptcy work? What went wrong in Lehman?
  - U.S. assets were quarantined in the UK. That can be fixed.
  - Barclays bought the broker-dealer, buildings, etc. Those activities and jobs continued.
  - The post-Lehman collapse came because the Reserve Fund had loaded up on Lehman paper and broke the buck. This sparked a panic from money markets and a lockup in commercial paper in which major corporations could not access their normal sources of liquidity.
- What if there is another Lehman?
  - Fed extends liquidity if there is collateral, with Treasury Secretary signing off on 13-3 authority.
  - If the problem is severe enough to require public capital, then Congress should vote. This is not “no more bailouts ever,” but it is a high bar.

# Tranching as an improvement to non-bank resolution?

- Is TARP-like tranching an improvement to non-bank resolution? The executive branch can spend up to \$150 billion and then must ask Congress for more money.
- It will be difficult/impossible to ensure that the amount of the first tranche does not get extended to cover a larger bailout.
  - \$150 billion can cover much more as a credit score, or if the Fed is willing to put its balance sheet after the TARP. This was the case with the TALF and the Citi and Bank of America ring-fence insurance schemes, which effectively circumvented Section 102 of the EESA TARP legislation.
- Once in for a dollar, we're in for the whole ride: will Congress pull the plug after the first \$150 billion is sunk?
- Financial engineering makes it is impossible to restrict the usage of funds to only the desired purposes. Allowing money to be spent without a vote of Congress is the Rubicon.
- The Frank-Dodd veneer of steps for the executive branch to follow to deploy money is just that—veneer. Non-bank resolution is inevitably a permanent TARP.

# Other issues

- OTC derivatives
  - Having derivatives go through a clearinghouse is fine, but it also concentrates risk.
  - Expecting standardization of derivatives is unrealistic: these are customized for a reason.
  - These provisions of the proposed legislation will effectively impose a “memo tax,” in which derivative sellers will write a note to explain why each instance is customized. This is bothersome, but not a fundamental impediment to financial innovation.
- 20 % haircut on secured lending (FDIC idea)
  - It will lead lenders to require an additional 20 percent collateral, thus reducing liquidity.
  - If the goal is to have more capital in the financial system, then require it directly and do not impair the useful role of secured finance.
  - FHLB is not the only lender that will want or require 100 percent collateral. Even with some carve-outs (FHLB etc.), this rule would lead to less liquidity and productive investments that are not made.
  - Note: an amendment in the House reduced the haircut to 10%, but the same concerns still remain.
- CFPA voting on a systemic risk decision?
  - It’s hard to imagine that any CFPA director will have relevant experience/knowledge. One could easily imagine a CFPA director using a systemic risk determination as leverage for unrelated decisions such as on regulatory issues.
- Ability to preemptively break up large firms
  - There are benefits for society from large financial institutions—not just costs.
  - A better approach is for regulators to impose capital charges on risky activities, not size. This will lead firms to organically adapt or shrink if they cannot raise appropriate capital.