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December 19, 2012

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Honorable Ben Bernanke,

We are sending you the latest policy statements adopted by the Shadow Financial Regulatory Committee (SFRC) that may be of interest to you for your consideration.

The SFRC, an independent group of experts sponsored by AEI, released its findings last Monday to address the upcoming implementation of Basel III in January 2013, to recommend to President Obama ways of improving regulatory standards enacted though the Dodd-Frank Act, and to comment on shortcomings of the Volcker Rule.

Specifically, the SFRC, which supports stronger regulatory capital requirements in the interest of stabilizing the global financial system, advises US regulators to abandon the Basel III regulations and enact superior regulation and enforcement strategies that adapt to dynamic markets. (Statement No. 332.) In its open letter to the President, the committee recommends that Congress provide future subsidies to housing activity through appropriations instead of through government-sponsored enterprises. (Statement No. 333.) Lastly, the committee commented that the Volcker Rule creates an ambiguous distinction between proprietary trading and market making, a distinction that unduly prohibits bank holding companies from engaging in proprietary trading. (Statement No. 334.)

We hope that you can give thought to the SFRC's latest findings, attached in this email, and take appropriate action in the interest of economic stability.

Sincerely,

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John F. Smith Professor of Finance and Economics

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Statement No. 332

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Statement of the Shadow Financial Regulatory Committee on

## Regulation of Bank Capital and Liquidity

December 10, 2012

The Shadow Financial Regulatory Committee believes that increasing regulatory capital and liquidity requirements – particularly for large institutions that receive too-big-to-fail subsidies – are essential for stabilizing the global banking system. Both the Dodd-Frank Act of 2010 and the new Basel III standards recognize this need to raise capital requirements and introduced liquidity requirements. Both U.S. and European regulators are currently seeking comments on proposals for enacting higher standards.

However, the conceptual approaches to prudential regulation embodied in the Basel III and the U.S. approaches suffer from fundamental deficiencies that require remediation. These deficiencies include (1) relying upon fixed risk weights for measuring risk-based capital that are arguably inaccurate, 2) relying upon fixed weights that, even if initially measured properly, inevitably will be wrong as market conditions change and will invite increased risk taking that misallocates banking resources, (3) constructing increasingly complex formulas used to measure liquidity in the new requirements, which are not sufficiently grounded in a sound conceptual framework, and that give a false impression of precision and adequacy, (4) establishing capital adequacy standards that are too low relative to either total assets or to any proper definition of risk-weighted assets, and (5) failing to institute any actions that address the problems of regulatory and institution forbearance that tend to result in a failure to promptly measure and respond to asset losses and capital impairment.

These problems reflect fundamental design flaws in the Basel III approach, and have characterized both Basel I and Basel II as well. Namely, they place too much reliance upon highly discretionary judgments of both bankers and regulators in measuring risk and capital. This resulted in the establishment of increasing detailed and complex formulas and that have also been subject to significant political bargaining that are often at odds with economic realities.

It is both possible and desirable to construct simpler and more effective rules for capital requirements. For example, one positive outcome of the Basel III process was the adoption -- for the first time -- of an internationally-agreed upon leverage ratio. However, that minimum ratio should be much higher. We are skeptical of arguments that higher equity requirements will increase the cost of credit significantly. Moreover, any increases in loan rates must be weighed against the benefits of increased safety and protection of taxpayers. We note that before the advent of federal deposit insurance, banks held much higher levels of capital.

What is new in the new Basel III rules is the establishment of liquidity requirements, but the Committee believes they are but another step in the wrong direction. The standards mandate that banks maintain sufficient liquidity, defined as meeting two different regulatory liquidity ratios: (1) the liquidity coverage ratio (LCR), that measures the ability of the bank to meet all of its required cash outflows during a period of funding stress lasting 30 days, and (2) the net stable funding ratio (NSFR), that focuses on the bank's longer-term liquidity position. But, the Basel Committee has not provided any theoretical or conceptual basis for these particular requirements.

The regulators state that there is a direct tradeoff between lengthening the maturity of bank liabilities as an alternative to holding more liquid assets. Reduced short-term debt is not necessarily a substitute for increased cash assets from the standpoint of ensuring liquidity. Moreover, changes in the maturity structure of bank assets and liabilities are not a substitute for increased capital. The recent financial crisis has reinforced the fact that institutions that have insufficient capital (and that may even be economically insolvent) are the ones most likely to experience funding and so-called liquidity problems. In fact, runs by short term creditors can, in the absence of too-big-to-fail, be the principal source of market discipline. Consequently, the relationships among asset liquidity, debt structure and capital are complex and are not independent from changes with market conditions.

To make matters worse, Basel III permits non-cash assets to qualify as liquid assets (with specified haircuts that lack an empirical basis). Some of those assets are not dependably liquid, and the haircut approach does not ensure that banks will actually have sufficient asset liquidity when they need it as market conditions change. Moreover, the approach fails to consider the fact that during a financial crisis, liquidity is dependent upon the existence of willing buyers of assets that banks may need to sell. In other words, asset liquidity is not a static characteristic of an asset, but rather is dynamic and varies with market conditions.

The Committee believes it would be better to focus liquidity regulation on requiring banks to maintain sufficient cash assets, narrowly defined to include vault cash and interest bearing deposits at the central bank. If liquidity requirements were defined in terms of holdings of such balances averaged over a specified period of time, like a month, then those reserve holdings would be available, perhaps subject to regulatory approval, to meet unanticipated needs for temporary (i.e. less than a few days) liquidity. Using an averaging period of a few weeks or a month would then allow an institution to meet a temporary liquidity need while allowing sufficient time to replenish its liquidity reserve position.

Finally, there are also severe problems with the Basel Committee's approach to measuring the liquidity risk inherent in different liabilities of differing maturities. The assumptions underlying the approach are both arbitrary and subject to great uncertainty. For example, there is no empirical basis for the assumptions made about the relative runoff risks associated with different liabilities. In particular, the assumption of 10 percent maximum run-off rate for "unstable," wholesale deposits may or may not be unduly optimistic, especially in light of the recent crisis.

We encourage U.S. regulators to walk away from Basel III and to enact regulation and enforcement strategies that are superior to the Basel III approach. An improved framework would be based on simpler rules for minimum ratios of capital to total assets and cash to assets that are less reliant on discretionary regulatory judgments about how to measure risk, capital, and liquidity. Such rules must be designed to be hard for bankers to get around through regulatory arbitrage, and hard for regulators and supervisors to ignore either because of politically-motivated forbearance or regulatory capture.

If effective capital and liquidity requirements were enacted, along with credible means of ensuring timely recognition of losses, it would more effectively protect society from the social costs of banking crises and bailouts of too-big-to fail banks, and permit regulators to minimize intrusion into bank activities in an attempt to preserve systemic stability. Banks, in turn, would be able to pursue business models that revolve around the logic of the market rather than the logic of gaming the safety net.

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Statement of the Shadow Financial Regulatory Committee on

**An Open Letter to President Obama**

December 10, 2012

In the arena of financial regulation, the Congress and your administration face a logjam of unfinished business and perverse lobbying pressures. The open letter that the Shadow Financial Regulatory Committee sent you four years ago (Statement no. 264 – December 8, 2008) identified five festering areas of special concern: 1) prudential regulation and supervision of financial institutions; 2) government policies that subsidize homeownership and housing activity; 3) rules defining the limits of safety-net protection for the financial system; 4) policies governing financial-institution consolidation and competition; and 5) disclosure standards and other rules ensuring transparency in complex financial instruments and deal-making arrangements.

Although the passage of the 2010 Dodd-Frank Act creates the appearance of progress, the Act does not settle any of these issues and actually increases moral hazard. Uncertainty about when and how these five issues will be resolved continues to impede business and household investment and job creation.

1. <u>Problems of Dodd-Frank:</u> The Dodd-Frank Act was enacted as the U.S. was recovering from one of the most serious financial crises in its history. Congress and the administration were eager to place their stamp on legislation that responded to the crisis. They acted hurriedly to respond to public demands for them to "do something"

to prevent the recurrence of the crisis and ease the recession that followed. In the two and a half intervening years, many elements of Dodd-Frank have come to light that exacerbate—rather than mitigate—the problems that gave rise to the crisis. These are outlined below in the hope that you will urge Congress to undertake needed reforms.

First is the fact that the crisis itself was less a failure of regulation than a failure of supervision. Heavily regulated banks did no better than lightly regulated investment banks. This should have raised questions about enforcement and regulatory performance rather than about the efficacy of the rules that were in place. Nevertheless, the crisis was seen as a rationale for developing more stringent rules. Second, many of the reforms put into place by Dodd-Frank gave more support to the idea that the government will protect the creditors of large financial firms, thus increasing moral hazard and reducing market discipline. Title I, for example, designates every bank holding company with $50 billion or more in assets as "systemically important," and subjects these 25 U.S. institutions to "stringent" regulation by the Fed. It also authorizes the Financial Stability Oversight Council to designate certain nonbank financial firms as systemically important, and subjects them, too, to stringent regulation by the Fed. This is an open invitation for the market—which doesn't need much encouragement—to treat all these institutions as too-big-to-fail (TBTF). When the market believes that a firm is TBTF the firm receives cheaper funding because it is perceived as less risky than its smaller competitors, but it also encourages more risk-taking because of reduced market discipline. Thus, while trying to control risk-taking with greater regulation, the Dodd-Frank Act actually increased it.

Third, since this Act's passage, the staffs of the Fed, OCC, FDIC, SEC, and CFTC have been drafting a plethora of new rules aimed at strengthening government supervision. Most of those have not been put in operational form, and many have not yet even been exposed for public comment. The primary goal of rule-making is to protect society by improving the ability of regulators to control risk-taking, but the uncertainties about policies and costs implicit in this impending regulation have been suppressing economic growth.

In dynamic markets, rules and their enforcement must be dynamic. To control moral hazard, your administration must work to ensure that regulators adapt to changes in the environment that change the effectiveness of regulations. Congress and regulators should be vigilant to make corrections in statutes and regulations when and as their costs begin to outstrip their benefits.

2. <u>Subsidization of Housing Activity</u>: Nearly everyone agrees that breakdowns in our nation's system of housing finance helped both to precipitate and to deepen the Great Recession. Nevertheless, your administration has yet to define the boundaries of the government's future role in housing finance or to develop a plan for transferring the assets held by insolvent government-sponsored housing-finance institutions (GSEs) to the private sector in an unguaranteed form. Instead, top officials repeatedly rehash the alternatives of privatizing, liquidating, or recapitalizing these firms without offering a convincing justification for pursuing one of these alternatives rather than another.

A particularly destabilizing feature of federal housing policy has been its predilection for relying on off-budget expenditures and mandates to increase homeownership and homebuilding activity. Off-budget funding of housing programs makes the true costs and benefits of housing programs impossible to measure and evaluate accurately. The programs in question include: the creation of implicitly subsidized mortgage institutions (i.e., Freddie Mac, Fannie Mae, the Federal Home Loan Banks, FHA, and Ginnie Mae) and the rules that govern their lending policies; favorable tax treatment of mortgage interest; lower risk-based capital standards for financial institutions on residential mortgage loans and GSE obligations; and legislation such as the Community Reinvestment Act that seek to expand riskier forms of mortgage lending.

Your administration should work with Congress to end the conservatorships of Fannie and Freddie and to recast politically determined efforts to promote housing as direct and transparent subsidies that could be targeted to explicitly approved recipients (such as low-income homeowners) at known costs that would be subject to regular budgetary review. Then, all other aspects of housing finance would be handled by the private sector.

3. Limits of Safety-Net Protection for the Financial System. During the crisis, bailout policies focused on symptoms rather than causes. Among the many causes of the crisis are explicit and implicit government guarantees and bailout programs that distorted market signals and undermined the effectiveness of private and government supervision. Not accounting properly for the risks and costs these programs impose on taxpayers reinforces incentives for government regulators that foster financial instability in the private sector.

Despite the anti-bailout provisions of the Dodd-Frank Act, in a future crisis authorities are likely to presume (as they did in this one) that financial institutions' problems in rolling over their debts arise from a shortage of market liquidity without investigating the extent to which these problems reflect reasonable doubts about the reliability of the estimates of accounting net worth reported by troubled institutions. Abandoning protocols for using prompt corrective action and bridge banks for resolving insolvent institutions established by the FDIC Improvement Act of 1991, officials undertook a series of ad hoc and short-sighted interventions into the affairs of giant bank and nonbank firms that has greatly expanded the US financial safety net. It is now generally believed that in similarly difficult circumstances the U.S. government will find a way to support most or all giant financial institutions, whatever their charter status or national origin. This might include not only money market funds but exchanges and derivatives clearing organizations located anywhere in the world. Eight central clearing parties have already been designated as "financial market utilities," which gives them emergency access to Fed funding.

Throughout the crisis, the Fed, Treasury and FDIC have reinforced this belief by pursuing unprecedented policies of institutional support and insolvency resolution that delivered hard-to-evaluate forms of bailouts to selected large institutions and their creditors (through direct government funding, asset and debt guarantees, and subsidies to acquirers of distressed institutions).

The expanded resolution authority established by the Dodd-Frank Act makes the avoidance of expensive future bailouts depend squarely on the vigilance, competence, and good intentions of future regulators. Your administration must work to limit the moral hazard and arbitrariness this authority entails. This can be done by formulating clear decision rules that assign accountability for the tax and transfer payments that bailouts produce.

4. Financial-Institution Consolidation and Competition. Expanding the safety net has adversely affected the size distribution, product lines, and locations of financial competitors. Institutions must not be encouraged to make themselves too large, too international, or too interconnected for authorities to fail or liquidate. The precedents established by the dramatic expansion of government protection of important markets and institutions during the crisis incentivize managers of giant institutions to increase their firms' size, complexity, and risk exposure at taxpayers' expense.

   Bailout policies followed during the financial crisis have caused the U.S. banking system to become increasingly top-heavy. The post-crisis industry structure shows an unbalanced size distribution which combines a handful of huge institutions with a large but shrinking number of smaller community and regional banks who are struggling to overcome the funding advantage that their larger competitors obtain from implicit guarantees.

   As the Great Recession recedes, the government must devise a process for orderly unwinding government protections and offloading risk from the Federal Reserve's greatly expanded balance sheet. Your administration must promote competition and further circumscribe access to bailouts to protect taxpayers, to ensure the efficiency of the financial system, and to enhance market discipline. The Dodd-Frank Act has had the opposite effect. It makes the moral hazard resulting from too-big-to-fail perceptions a more significant issue than ever before

5. Innovative Financial Instruments and Deal-Making Arrangements. Managers of giant institutions know that hiding loss exposures that pass through to the safety net by transacting in ever more complicated and opaque instruments can increase short-term profits and enhance profit-based executive compensation. By simultaneously tolerating declines in accounting transparency from the increased complexity of institutional portfolios and methods of arbitraging away the burden of capital requirements and other prudential measures, supervisors encouraged the underpricing of risk, and the sudden correction of this underpricing triggered the crisis. The crisis punished investors who accepted more risk than they thought they had bargained for, borrowers who overleveraged themselves, citizens who lost their jobs or homes, and taxpayers who are apt to be presented with the bill for the mess.

   Regulators and supervisors have a duty to see that risks can be fully understood and fairly priced by each of these groups. To do this requires a reorientation of government regulation, aimed at producing an efficient layering of private and governmental discipline.

To reduce opportunities for forbearance by regulators, this Committee has supported the concepts of the Prompt Corrective Action program (PCA) and Structured Early Intervention and Resolution (SEIR) as specified by the FDIC Improvement Act of 1991 (FDICIA). PCA and SEIR mandate a ladder of increasingly harsh regulatory sanctions. The Committee also favors expanding the information available to regulators and market participants by requiring banks to issue subordinated and convertible debt whose fluctuations in market price would supplement other market and supervisory signals about the financial health of the issuing institution and provide additional protection against safety-net costs.

In view of continuing and partly regulation-induced evolution in financial instruments, the Committee reiterates its recommendation that supervisors be obliged to look for ways to extract additional information about the riskiness of large financial institutions from new financial instruments as they emerge. Supervisors have already proposed to use data on (admittedly thinly traded) credit default swaps (CDS) to assess institutional risk.

A CDS provides insurance against defaults on designated obligations. In fact, taxpayers' stake in a protected institution is functionally equivalent to a CDS. The value of this stake could be priced by the market if equivalent swaps were issued publicly and traded regularly.

Prices of safety-net CDS could help authorities to assess how well capital requirements and other prudential controls were working and would provide fresher and more accurate information on an institution's financial well-being than accounting statements or yields on observed infrequently traded debt.

Your administration should work with regulators to see that protected banks, bank holding companies, money market funds, exchanges, and derivatives clearing organizations make more transparent the risks they impose not only on investors, creditors, and counterparties, but also those that pass through to taxpayers. A good start would be to require regulators to develop ways of measuring the value of the risks that these firms shift onto the safety net. Reports could be prepared and self-reported on a regular basis by any institution designated as systemically important. Of course, the information provided by these measures would have to be routinely reviewed and tested by regulatory personnel. Such information would lead to an improved understanding of the relationship between an institution's risk exposure and its profitability, and provide guidance to regulators seeking to lessen the incentive for protected firms to shift risk onto the safety net.

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Statement No. 334

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Statement of the Shadow Financial Regulatory Committee on

**Glass-Steagall and the Volcker Rule**

December 10, 2012

Recently, several commentators, including some prominent former banking executives and regulators, have expressed the view that the banking activities limits in the original 1933 Glass-Steagall Act should be reinstated. These statements have provoked an avalanche of comment about the benefits of separating commercial banking from securities underwriting and dealing. In addition, the Volcker Rule—which, because it restricts proprietary trading by banks, is seen by many people as a return of Glass-Steagall—has turned out to be a controversial provision of the Dodd-Frank Act. The Committee does not believe that Glass-Steagall should be reinstated, and sees no persuasive rationale for the Volcker Rule.

The 1999 partial "repeal" of Glass-Steagall in the Gramm-Leach-Bliley Act (GLBA) eliminated some restrictions on the ability of bank holding companies (BHCs) —but not insured banks—to engage in underwriting and dealing in securities. Although this also can be seen by some as permitting BHCs to take greater risks through securities activities, it had little if any effect on the problems banks and BHCs encountered in the 2008 financial crisis.

The commercial banks and parent holding companies that got into trouble in 2008 did so principally by acquiring and holding large amounts of mortgage-backed securities (MBS) that had pooled subprime and other low quality mortgages. Insured banks were always permitted under Glass-Steagall to acquire, and to buy and sell, MBS because these instruments were regarded as loans in securitized form. Similarly, the five largest investment banks that got into financial trouble in 2008—Bear Stearns, Lehman Brothers, Goldman Sachs, Morgan Stanley and Merrill Lynch—were not affiliated with insured commercial banks. They also got into trouble by holding the same MBS backed by subprime or low quality loans. Accordingly, since the crisis was not related to anything that would have been prevented by Glass-Steagall, nothing about the financial crisis would have been different if the GLBA's Glass-Steagall repeal had not been adopted.

Reinstating Glass-Steagall would prevent bank holding companies (BHCs) from engaging in securities underwriting and dealing. Since there is no indication that the partial repeal of Glass-Steagall in the GLBA was a proximate cause of the financial crisis, reinstating the Act's restrictions would unnecessarily weaken BHCs by reducing their ability to diversify without in any way protecting the safety net.

Dodd-Frank's Volcker rule—which prohibits insured commercial banks and their affiliates from engaging in what the rule calls "proprietary trading"—bears some superficial resemblance to Glass-Steagall but in some respects it is more restrictive and in other respects less so. It goes further than Glass-Steagall because it prohibits proprietary trading of all securities, except U.S. government debt securities, by all "bank-related entities." This is a broader prohibition than Glass-Steagall, which (before its amendment by the GLBA) prohibited banks and BHCs from underwriting and dealing in corporate debt and most municipal revenue bonds, but permitted banks and BHCs to trade in these instruments. Generally, "dealing" in a security means holding an inventory of securities to buy and sell with third parties, while "trading" involves buying and selling for advantageous investment or profit purposes. Thus, the Volcker rule imposes a more restrictive regime on banks and BHCs by prohibiting proprietary trading of all securities—foreign sovereign bonds, state and local bonds, and revenue bonds—except U.S. government securities. This restriction is likely to reduce the liquidity in the markets for these securities and thus raise financing costs.

The Volcker Rule goes less far than Glass-Steagall because it contains exceptions for underwriting, hedging and market making. In other words, although insured banks could not underwrite or deal in fixed income securities under Glass-Steagall, they can engage in underwriting, making markets and hedging under the Volcker Rule. The difference between proprietary trading and making markets, hedging and underwriting is extremely difficult to define clearly, especially in regulatory language, which explains why the Volcker Rule's implementation by the regulators has been delayed. In effect, the Volcker rule restricts all securities trading by commercial banks, BHCs and their nonbank affiliates to trading only for the account of customers, market-making, and their own hedging transactions. Since there is no evidence that proprietary trading played any significant role in the 2008 financial crisis, the Committee sees no persuasive argument in favor of the Volcker Rule's prohibitions on all trading within bank holding companies.

Proponents of the Volcker Rule believe that proprietary trading is speculative and a risky use of insured deposits in ways that impose undesirable risks on taxpayers. But the Volcker Rule also applies to BHCs and their nonbank affiliates which have limited or no access to either federally insured deposits or the Federal Reserve's discount window. In addition, The Committee notes that banks have ample ways to take large risks as the recent financial crisis and the role played by banks investments in mortgages and mortgage-related securities demonstrate.