

Principles on Financial Reform: An Analytical Framework

A Bipartisan Policy Statement

March 2010

(This document reflects the views of the Pew Task Force on Financial Reform. The recommendations are solely those of the signatories of the Principles of Financial Reform, December 2009. The Pew Charitable Trusts takes no position on any of these recommendations.)

Forward

In the years leading up to the financial crisis of 2008, shortcomings in financial regulation contributed significantly to a near-collapse of the U.S. financial system, which triggered a deep world-wide recession. In response the Administration, Congress and several groups have developed proposals for reform. The Pew Charitable Trusts launched its Financial Reform Project in March 2009. The Task Force was formed in May.

The Task Force is a group of prominent scholars and financial market experts with disparate views and philosophies. It has been working to build bipartisan consensus on the major federal financial reform issues. The Task Force members are listed below:

Co-Chairs:

- *Martin Baily, Senior Fellow, Economic Studies at the Brookings Institution
- *Peter Wallison, Senior Fellow at the American Enterprise Institute*

Other Members:

Alan Blinder, Professor of Economics, Princeton University

*Charles Calomiris, Professor of Finance and Economics, and International Economy at Columbia University

Rodgin Cohen, Senior Partner, Sullivan & Cromwell

*Morris Goldstein, Senior Fellow at the Peterson Institute for International Economics

Daryl Hendricks, _____, UBS

*Richard Herring, Professor of Finance, University of Pennsylvania

*Robert Litan, Vice President, Research & Policy at the Kaufmann Foundation and Senior Fellow Economic Studies at the Brookings Institution

*Paul Mahoney, Dean of the Law School at University of Virginia

*Avinash Persaud, Chairman of Intelligence Capital Limited

*Alice Rivlin, Senior Fellow at the Brookings Institution and Visiting Professor at Georgetown University

*Robert Steel, former CEO of Wachovia Corporation and former US Treasury Undersecretary for Domestic Finance

*Benn Steil, Senior Fellow and Director of International Economics at the Council on Foreign Relations

John Taylor, Professor of Economics, Stanford University

In December 2009 Pew released *Principles of Financial Reform*, a document signed by 11 of the 15 members of the Task Force (indicated by an asterisk next to their names above) that contained a series of recommendations for reforming the financial system. While the Task Force was not able to address all aspects of financial regulation and some signatories would have preferred different approaches with respect to certain individual recommendations, the signatories of the *Principles* statement believed then and continue to believe strongly that the entire package of recommendations set forth in that document would significantly improve the financial regulatory system in the United States.

Given the press of time, the *Principles* statement did not fully elaborate the reasons for the recommendations, as well as their limitations, or provide a discussion of the alternative recommendations that were discussed at and between the various Task Force meetings, including meetings we have had since the *Principles* statement was released in early December, 2009.¹ This *Analytical Framework* is our attempt to this void.

¹ Two of the Task Force members, Rodgin Cohen and Daryll Hendricks, did not sign the *Principles* statement because of apparent conflicts with the positions of their employers. While this document explains differences in views among the Task Force members on certain subjects – differences which were sufficient to lead two Task Force members, Alan Blinder and John Taylor, not to sign the *Principles* statement – it does not identify any positions with particular individuals.

Introduction

By now, it is well understood from the many academic and journalistic accounts of the financial turmoil of 2007-08, that the crisis had multiple reinforcing causes, which in combination produced an economic and financial "perfect storm":

- lax lending standards on the part of the government-sponsored enterprises; mortgage lenders and other consumer lenders;

- excessive government subsidization of mortgages;

- a relatively long period of low short-term interest rates, coupled with the heavy, continuous inflow of global savings that suppressed long-term interest rates;

- imprudent consumer borrowing;

- the widespread perception that U.S. housing prices would not fall;

- the explosion of new forms of non-transparent, complex and ultimately dangerous securitized instruments and other financial products;

- excessive leverage and inadequate risk management at many financial institutions;

- irresponsible behavior by rating agencies; and

- the mispricing of risk by too many participants in the financial system.

It is likely that these causes will be even better understood, and may even be supplemented, when the official Commission created by the Congress to investigate the causes of the crisis issues its final report in December 2010.²

While the blame for the near collapse of the financial system and its devastating consequences must be widely shared and cannot all be laid at the door of inadequate regulation only, the crisis also highlighted serious weaknesses in the U.S. financial regulatory structure. Regulation cannot and should not attempt to eliminate ups and downs in financial markets or the real economy, which are inherent in capitalist economies, but improved regulation surely must and can reduce both the frequency and severity of future crises.

It is in pursuit of that objective that in May 2009, the Pew Charitable Trusts formed the Pew Task Force on Financial Reform, consisting of 15 noted experts in finance. Many of the members have served in high-level governmental capacities, especially those related to financial policy

² One of the Commission's members, Peter Wallison, is a co-chair of the Pew Task Force.

making. Others have extensive practical or academic experience in finance. A number of members have all these backgrounds.³

The Task Force deliberately has members identified with both political parties to ensure that its recommendations reflect a bipartisan consensus of experts. All of the members, prior to joining the Task Force, had been extensively quoted in the media, or had published views about either or both the causes of the crisis and what ought to be done to prevent future ones like it. Nonetheless, the members came together to learn from one another and to identify and debate and merits and pitfalls of some (but not all) of the options for reforming the regulation of the U.S. financial system in particular. Going into these deliberations, the members shared the conviction that reform was both desirable and necessary. While no one believed it possible to eliminate all risk of future financial crises – an objective, given hundreds of years of historical experience, that is impossible to achieve – the Task Force believes that policy makers can and must do their best to ensure a more stable financial system and economy in the future.

Below we first summarize the five broad categories of recommendations set forth in the *Principles* statement signed by 11 of the 15 Task Force members. In the balance of the document, we provide context for the recommendations; discuss their rationales, including advantages and weaknesses; and identify and discuss various alternative ideas that we debated and certain of the members supported.

Since the *Principles* statement was issued, the House of Representatives enacted comprehensive financial reform legislation. A number of ideas similar to those included in that statement are included in the House bill. At this writing, the Senate is considering various financial reform proposals, some similar to and others different than those in House. Some proposals in the Senate also are similar to those included in the *Principles* statement.

The Task Force hopes that the ideas embodied in that earlier statement and in this expanded document will be useful to both legislative chambers as they seek to enact a comprehensive reform package that is accepted by both bodies and by the Administration. Given the magnitude of the financial crisis and subsequent recession that this nation and other countries have experienced, comprehensive reform could not be more urgent or necessary.

³ During the course of our deliberations, we received papers and visits from a number of experts on various topics. We are grateful to all those who gave us the benefit of their time and wisdom.

Summary

During the first six months of its deliberations, the Task Force identified five broad areas in which financial reform was both necessary and urgent. The *Principles* statement, signed by 11 of the 15 Task Force members, contained the following areas of recommendations. As noted in the Forward, the signatories agreed to these recommendations *as a package*. Thus, while individual signatories may have preferred other approaches to certain of the recommendations, all of them agreed that, as stated and taken together, the recommendations would significantly improve the regulation of the U.S. financial system and make it less prone to financial crises in the future.

1. Systemic Risk and Macro-Prudential Regulation

A new Financial Services Oversight Council (FSOC) should oversee policy on systemic stability. That policy should be developed in consultation with the Federal Reserve (Fed). If signs of stress emerge, the FSOC should initiate action, based on consideration of specific responses recommended by the Fed. Once approved by the FSOC, interventions should be implemented by the relevant federal financial regulatory agencies. The Fed should retain observer status on examinations of specific institutions, as well as the authority to collect any information directly from financial institutions and markets relevant to monitoring systemic risk that is not available from their primary supervisors.

2. Large Complex Financial Institutions

The larger and more complex an institution, the higher the standards for capital, liquidity and leverage to which it should be held. Large institutions should maintain regulator-approved wind-up plans and, if they cannot, they should be required to shrink. *No institutions, however large or complex, should be "too big to fail."*

Depository institution failures should continue to be handled by the FDIC. A hybrid resolution procedure should be adopted for non-depository financial institutions: the default approach should consist of a strengthened bankruptcy process, with an administrative resolution process available as a backstop (only in exceptional circumstances under strong safeguards). In all circumstances, shareholders in a failing institution should lose their investment, senior management responsible for the institution's failure should lose their jobs, and all unsecured creditors should face some haircut.

3. Micro-prudential regulation and consolidation

A new National Financial Regulator (NFR) for safety and soundness regulation should be created by combining the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). The NFR also should take on all of the micro-prudential responsibilities of the Fed, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the Federal Housing Finance Agency (FHFA). Within the NFR, the FDIC should retain distinct roles for resolution of failed banks and administration of the deposit insurance fund.

The NFR should ensure that the institutions under its watch abide by significantly higher (but phased-in) capital standards than those that pre-dated the crisis. Large banking organizations also should be required to issue long-term uninsured and unsecured (subordinated) debt that converts to equity in times of stress. Strong liquidity standards should be introduced. Regulation should focus on risk governance and management as much as measurement. Examinations of specific institutions should be strengthened.

4. Strengthening Markets and Market Discipline

Derivatives trading can be made safer and less a source of systemic risk in several ways. Over-the-counter (OTC) derivative transactions should be recorded with trade registries to ensure transparency. Collateral in OTC transactions should be managed by third parties. The migration of OTC transactions onto clearing houses and exchanges should be encouraged through capital requirements assessed on OTC instruments that are not centrally cleared.

Elsewhere, market discipline can and must be strengthened. A private Securitization Board should be created to establish best practices at every stage of securitization, including credit ratings. Risks that arise from using inaccurate credit ratings in regulation should be addressed. Executive compensation should be aligned with risk in financial institutions. A subordinated debt requirement for large banking organizations will strengthen market discipline of these institutions in particular. The FHA and the GSEs should be reformed.

5. Consumer Protection

A new federal Consumer Financial Protection Agency (CFPA) should be created with the sole mandate of protecting consumers of financial products and services. The CFPA should have powers of rulemaking, enforcement and preemption of state rules. All the powers for consumer protection for financial products and services currently assigned to federal financial regulatory agencies should transfer to the CFPA. The other federal financial regulatory agencies should be represented on the CFPA Board to ensure balanced deliberation and coordination of policy.

Discussion and Analysis of Recommendations and Other Alternatives

In this section, we lay out the considerations and reasoning that led to the foregoing recommendations, as well as other options the Task Force considered. The Task Force members did not choose to tackle every single reform issue that either body of the Congress has chosen to examine or outside observers have suggested. Instead, we concentrated on five of the key areas where we believe we had expertise and where, in light of the events that transpired in the period running up to and including the financial crisis, reform is clearly and urgently needed. Even in these areas, which follow, we did not address or resolve every detail of implementation (and, where those omissions are significant, we note them):

--The need to provide oversight of the entire financial *system* ("macro-prudential regulation"), and not just of individual financial institutions;

--The need to end "too big to fail";

--The need to streamline and strengthen the regulation and supervision of the safety and soundness of specific financial institutions ("micro-prudential regulation"), banks and their holding companies in particular;

--The need to ensure that over-the-counter (OTC) derivatives markets are not a source of systemic risk, and generally to strengthen market discipline throughout the financial system; and

--The need to improve the regulatory protection of consumers of financial products and services.

The Task Force will continue to consider reform issues not addressed in the Principles statement in the months ahead and thus may issue one or more supplements to this report.

Systemic Risk and Macro-Prudential Regulation

The financial crisis of 2007-08 began with rising delinquencies among subprime mortgages and the complex securities on which they were based and, like a highly contagious virus, spread quickly throughout an excessively leveraged financial system that turned out to be far less resilient than was widely believed at the time. The crisis exposed many weaknesses in our financial system, and in the laws, regulations and institutions that had been established to ensure its soundness. Correcting these weaknesses is clearly a matter of urgent importance.

Thus, while federal and state regulators have long been charged with overseeing the solvency of *individual* financial institutions – banks in particular, but also insurers that proved to be susceptible to this particular crisis – no single regulator or group of them was charged with monitoring and understanding the interconnections among the various institutions and financial markets, the gaps in regulation that allowed certain institutions to take excessive risks, or detecting early signs of systemic threats and acting to mitigate them. Put differently, we had a

system of *micro-prudential regulation* (which also did not perform well), but no system of *macro-prudential regulation* or even monitoring.

The Task Force discussed the notion of systemic risk extensively, recognizing that it is a concept that is both difficult (if not impossible) to define with precision. Nonetheless, a useful working definition is that systemic risk can arise if one or more events of a financial nature – such as the failure of one or more large financial institutions (banks in particular) or a sudden and sharp fall in equity prices – is of sufficient magnitude as to cause a significant and sustained drop in the output of goods and services. Whatever the definition, federal policy makers in 2007 and 2008 took a variety of unprecedented actions – rescuing the creditors not only of large banks, but of the nation’s largest insurer; guaranteeing deposits at all money market funds; and injecting government funds into many banks and some insurers – because they *feared* the systemic risks of not acting.

Looking ahead, a key challenge for policy makers is to identify sources of potential systemic risks in the future and take appropriate steps to mitigate them. For example, several years ago there were widely recognized signs of unusual credit expansion and increases in leverage associated with an unprecedented rise in housing prices. These developments signaled the beginning of a bubble with the potential to destabilize the entire system, yet no countervailing action by any government agency was taken. We need an institutional mechanism to prevent future bubbles in any number of asset markets from having similar or even less damaging results.

The Task Force identified two aspects of such a mechanism. First, some organization or body should be charged with *monitoring* the financial system to determine the formation of possible bubbles, undue credit expansion, or other aspects of the system (such as interconnections between financial institutions and markets) that give rise to systemic risk. Second, one or more regulatory bodies should *take appropriate actions* to mitigate systemic risk, without significantly curtailing the growth of the overall economy.

Options for The Systemic Risk Monitor

The Task Force discussed three different options for the systemic risk monitor: creating a new systemic risk agency (which could be part of the National Financial Regulator, discussed below); designating the Federal Reserve Board as the systemic risk monitor; or giving monitoring responsibilities to a new multi-agency body composed of the heads of key financial regulatory agencies (as suggested by the Administration, is included in the House bill and is currently being considered by the Senate).

Creating a new agency to monitor systemic would have several advantages. It would not divert existing financial regulatory agencies from their current responsibilities, nor would it put those agencies in a position of conflict with those responsibilities. For example, a bank supervisor may be hesitant to call attention to systemic risk if doing so could trigger a reduction in the market value of assets widely held on bank balance sheets, thereby weakening the banks under its supervisory jurisdiction. This is also a reason not to add systemic risk responsibilities to the NFR. Nonetheless, a major drawback to creating a new agency for monitoring systemic risk is that this

would further complicate an already crowded and less-than-rational regulatory system. Primarily for this reason, the *Principles* statement did not endorse this option.

The *Principles* statement also did not endorse the Federal Reserve Board as the systemic risk monitor. Even more so than in the case of assigning monitoring authority to a new agency, the Fed could be put in a position of conflict with its monetary and supervisory functions (assuming it retains the latter, an issue we explore below) if it were also charged with the sole responsibility for monitoring systemic risk. In either case, the Fed could be reluctant to alert the public to mounting systemic risk if such a warning could complicate its ability to carry out monetary policy effectively and/or adversely affect the financial institutions that the Fed supervises and examines.

Another reason to look beyond the Fed in assigning the systemic monitoring function is that this activity could benefit from the input from individuals and agencies with different responsibilities and perspectives relating to the financial system. The Fed's chief responsibilities are to manage the economy's money supply and to serve as a lender of last resort in the event of systemic crises. The Fed carries out these responsibilities chiefly by buying and selling securities from the commercial banking system, and up to now, has had supervisory responsibilities for financial and bank holding companies and for the roughly 1,000 state banks that belong to the Federal Reserve System. Accordingly, the Fed understandably looks at the overall economy – and the systemic risks it might face – through the lens of the banking system. The Fed does not and should not be expected to have the same level of expertise with respect to other parts of the financial system – such as securities and derivatives markets, insurance companies, and other non-banking financial institutions (except financial holding companies) -- where systemic risk also may arise.

There are counter-arguments, however, in favor of choosing the Fed as the systemic risk monitor. Although the Fed has close oversight and understanding of the banking system, its monetary and lender-of-resort functions inherently require understanding of the workings of the entire economy, including the monitoring of factors or trends, such as bubbles in asset and credit markets, which can lead to systemic risk. Indeed, one might argue that the Fed has already *has* the de facto responsibility for monitoring systemic risk, and thus it is a natural institution to have this authority formally.

In weighing these arguments, the signatories of the *Principles* statement took the view that having multiple agencies at the table was the more decisive factor, but with the Fed playing an especially important role (discussed shortly). There is ample precedent for involving multiple agencies in overseeing systemic risk. In March, 1998, President Reagan created the President's Working Group on Financial Markets (PWGFM) in March, 1998 following the stock market crash in October, 1987, to coordinate policy toward financial markets and institutions among the major agencies with financial regulatory responsibility.⁴ The membership of the PWGFM has included the Chairman of the Fed, the Secretary of the Treasury, and the Chairmen of the Securities and Exchange Commission and the Commodities Futures Trading Commission. The

⁴ The PWGFM was formally created by Executive Order 12631.

PWFGM has met regularly since its inception, through four successive Presidential Administrations, and is widely regarded as a successful institution.

The *Principles* statement endorses the thinking behind the creation of the PWFGM, but urges that the multi-agency body charged with overseeing systemic risk be more inclusive than that coordinating body. *In particular, the statement recommends the creation of a new Financial Services Oversight Council (FSOC) that has as its members the current members of the PWFGM plus the Chairman of a newly created National Financial Regulator (NFR) and of the Federal Deposit Insurance Corporation (FDIC) and the Director of the newly created Consumer Financial Protection Agency (CFPA).*

The Task Force has not agreed upon the choice of a chair for the FSOC, and whether it should be rotating or permanent. If a permanent Chair is chosen, the two logical options are the Chairman of the Federal Reserve or the Secretary of the Treasury. Both individuals and the institutions they represent have broad authority over the workings of the nation's economy and thus would be appropriate chairs. The choice between the two rests on one's views about the relative virtues or drawbacks of having the chair come from an independent agency (the Fed) or one from the Executive Branch reporting to the President (Treasury).

Functions of the FSOC: Mitigating Systemic Risk

As envisioned in the *Principles* statement, the FSOC would monitor the financial system and approve and oversee policy on systemic stability. The FSOC should have its own small staff. The statement also recommends that, given its central roles as the nation's monetary authority and lender-of-last-resort, the Fed should not only be consulted by the FSOC about systemic risk policy, but should also provide recommendations for policy actions to the FSOC.

The policy on systemic stability should specify how combinations of indicators of potential systemic distress – including, but not limited to, the expansion of credit and prices of housing and other large asset classes -- should be identified, monitored, measured and analyzed. The policy should specify how and under what circumstances the various federal financial agencies should respond with measures to encourage stabilizing behavior. Examples include higher than normal standards on micro-prudential capital, reserves, margin and leverage requirements (including loan-to-value ratios for mortgages) across financial institutions and markets. Such counter-cyclical systemic stability tools are potentially more effective in controlling asset-price bubbles than interest rate policy alone.

If signs of impending financial stresses emerge, the FSOC should initiate actions, taking into account the recommendations of its members and any specific responses suggested by the Fed, aimed at reducing systemic threats at minimum cost to the overall economy. Once approved by the FSOC, interventions designed to mitigate systemic risks should be implemented by the relevant federal financial regulatory agencies. The FSOC should oversee the impacts of those interventions, and be prepared to recommend additional measures, as situations warrant.

While the *Principles* statement recommends that the Fed no longer engage in any micro-prudential regulation (as discussed below),⁵ the statement also recommends that the Fed retain observer status in examinations of specific institutions, particularly large complex financial institutions. In addition, the statement urges the Fed to be given the authority and resources to collect and verify any information from financial institutions and markets that would not be available through inter-agency coordination and would be relevant to the Fed's systemic stability or lender-of-last-resort responsibilities. Any data collected by the Fed and its analyses should be reported regularly to the FSOC members as a whole. The Statement also recommends that the Fed be responsible for research on systemic stability and for the improvement of macro-prudential regulation over time.

Any body that has systemic risk responsibilities (whether the FSOC, the Fed, or a new agency) should be accountable to the public and to Congress as well as the President. This is best done through regularly published reports and testimony describing current challenges to maintaining or reviving the stability of the financial system, and what measures were in place or underway at its constituent bodies to maintain or revive it.

Combining all of these insights, the signatories of the *Principles* Statement agreed on the following ways to oversee systemic risk and to accomplish macro-prudential regulation.

A new Financial Services Oversight Council (FSOC) should oversee policy on systemic stability. That policy should be developed in consultation with the Federal Reserve (Fed). If signs of stress emerge, the FSOC should initiate action, based on consideration of specific responses recommended by the Fed. Once approved by the FSOC, interventions should be implemented by the relevant federal financial regulatory agencies. The Fed should retain observer status on examinations of specific institutions, as well as the authority to collect any information directly from financial institutions and markets relevant to monitoring systemic risk that is not available from their primary supervisors.

Large Complex Financial Institutions: Ending "Too Big To Fail"

The federal rescues of the creditors of various large, complex financial institutions (LCFIs) have underscored a central dilemma.⁶ On the one hand, such institutions, at least as they were structured and regulated pre-crisis, were deemed by policy makers to be too large and/or interconnected with other institutions and markets to permit their creditors (not just bank depositors) to suffer any loss for fear that such losses could cascade throughout the financial system and/or that the losses could trigger contagious "runs" by similarly situated creditors at other financial institutions. On the other hand, knowing all this to be the case creates a significant "moral hazard" by reducing, if not eliminating, any incentive for creditors of LCFIs to monitor and discipline their managers against excessive risk-taking. Precisely for this reason,

⁵ As the subsequent discussion indicates, not all members of the Task Force agree that the Fed should be removed from all micro-prudential regulation.

⁶ "LCFIs" is shorthand for the institutions that have a combination of size, complexity, interconnectedness, leverage, maturity mismatch, or dominant role in a major market or activity that would make their failure potentially particularly disruptive to the financial system.

Federal Reserve Board Chairman Ben Bernanke (among many others) has called this “too big to fail” (TBTF) situation “one of the biggest problems we face in this country.”⁷

The Task Force wholeheartedly agrees with the Chairman’s assessment as well as his conclusion that “we must take action to eliminate too big to fail.”⁸ The critical question is how to do this without jeopardizing the stability of the financial system in future crises.

The Task Force discussed a wide number of broad ideas and approaches for accomplishing this important objective, especially the following four:

- Regulating in a way that makes LCFIs less likely to fail in the future;
- Requiring LCFIs (or an even broader class of financial institutions) to maintain approved “wind-up” plans in the event they run into financial difficulties;
- Establishing new procedures and mechanisms for resolving failed financial institutions (and especially LCFIs) in ways that imposes losses on all relevant parties (shareholders, unsecured creditors, and managers);
- Breaking up financial institutions whose size and/or complexity pose undue risks that they will be treated as TBTF in the event they encounter future financial problems.

The *Principles* Statement reflects all four of these ideas.

Regulating To Reduce The TBTF Problem

Despite being officially “well capitalized” by conventional measures, many LCFIs in the United States (and elsewhere) in fact were weak going into the crisis. Risk management had become ineffective (with some risks ostensibly moved “off balance sheet” to Structured Investment Vehicles, or SIVs, only to return as the crisis unfolded), complexity had become unmanageable (with some institutions having more than 1000 separate subsidiaries or legal entities), leverage had become excessive, and liquidity and high quality capital were in short and uncertain supply. When the crisis hit, federal authorities were unprepared to deal with the serial collapse of many institutions that followed. Confusion over which institutions would be allowed to fail without intervention, and what the consequences of disorderly failure might be simultaneously heightened moral hazard, the scale of the market disruption and the costs to the taxpayer.

⁷ Chairman Bernanke is cited making this statement in the *Time* magazine issue that named him 2009 “Person of the Year,” December 28, 2009-January 4, 2010, pp. 76-78. The notion of TBTF is widely misunderstood. The institutions whose creditors may be “bailed out” still generally “fail”, in the sense that their shareholders lose most or all of their investments. But their creditors are also typically the largest sources of outside funding, and unlike shareholders who not only bear downside risk if their companies do poorly but benefit when their companies do well (and thus can profit when financial institutions take risks), creditors earn a fixed return and bear only downside risk. For this reason, actions or anticipated actions by policy makers that shield creditors from losses remove the most important source of market-based discipline against excessive risk-taking by managers of the affected financial institutions.

⁸ *Ibid.*, p. 78.

Accordingly, the *Principles* Statement recommends that going forward, and after some suitable phase-in period, *capital, liquidity and leverage requirements should rise with the size and complexity of the institution.*⁹ Larger, more complex institutions pose greater risk to the system and these risks should be internalized. Moreover, a more conservative capital structure should strengthen governance and provide a greater buffer in the event that the institution faces difficulties.

It is difficult to know in advance of a crisis which institutions will pose the greatest risk. Institutions should not have an incentive to manipulate their size or scale to just (dis)qualify for “Too Big to Fail” status if that is seen as conferring commercial (dis)advantages. Moreover, to segregate institutions in advance and identify them for special regulatory treatment is very likely to perpetuate the perception that some are “too big to fail” and consequently pose less risk to counterparties and creditors. In principle, stricter regulation might be able to offset this moral hazard risk. But because regulation itself – especially enforcement of capital and leverage requirements, which requires judgment about asset valuation – can be imperfect, specifying a list of LCFIs subject to clearly different (albeit tougher) regulatory standards can still entail moral hazard.

Of course, investors, creditors and analysts will be able to discern from public financial reports which institutions are maintaining higher capital and liquidity ratios, and thereby conceivably infer that those institutions have TBTF status. The signatories of the December, 2009 believe that the best way to reduce this problem is to ensure that the schedules of capital and liquidity requirements have no sharp jumps or thresholds that result in different regulatory treatment for different classes of institutions. This approach, combined with the other measures in this section that follow, provides the best protection against the possibility that third parties will infer that specific institutions have *de facto* TBTF status.

Regulator-Approved Wind-Up Plans For Large Financial Institutions

As a second prong of the plan to end TBTF, the *Principles* Statement recommends that financial institutions above a certain size should maintain a wind-up plan approved by the newly created National Financial Regulator (NFR), discussed shortly. Although events during troubled times may make it difficult or impossible to follow any wind-up plan in exact detail, the preparation and approval of such plans, especially for LCFIs, has several virtues:

--The plan would help guide any resolution authority in winding up the affairs of any large institution, especially those with complex organizations and multiple subsidiaries.

--With a wind-up plan, federal authorities would feel less pressure to bail out any parties, especially creditors.

⁹ There is a difference of view within the Task Force regarding the regulation of non-bank institutions. Some believe that non-bank financial institutions should not be subject to safety and soundness regulation like banks, and should be free to take any risk the marketplace will allow. Others believe that non-bank LCFIs in particular should be subject to bank-like regulation.

--The discipline of preparing the plans and gaining regulatory approval for them would help managers and directors restructure their institutions if necessary to reduce risks to the institution (and to counterparties).

--As discussed below, the *Principles* Statement recommends that if the NFR decides that an institution's plan is inadequate and persistently weak, the NFR have the authority to force the institution to divest certain businesses (and thus shrink) in order to significantly reduce the risk of spillovers to the rest of the financial system in the event of the institution's failure.

[Provisional language: The Task Force discussed the merits and drawbacks to making the wind-up plans public. The principal advantage of publicizing the plans is that this would put all parties, and especially creditors, on notice of their risk of loss and under what circumstances, and thus directly address the TBTF problem and the moral hazard it entails. The drawbacks to public disclosure are that this might inhibit the frank give-and-take between the institution and the NFR that is likely to be an important part of the approval process for these plans. **The issue of public disclosure to be discussed further?]**

Improved Resolution Mechanisms and Procedures for Non-Bank LCFIs

Perhaps the most important prong of any plan to end TBTF is to improve current resolution procedures for non-banks (including bank holding companies and financial institutions other than banks), especially for LCFIs, or precisely those institutions whose troubles may prompt authorities to provide bailouts. There is no need for, nor does the Task Force recommend, changing the existing resolution system for failed banks, which is administered by the FDIC. Under that system, the FDIC is required under the "prompt corrective action" provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) to take progressively tougher actions to curtail further risk-taking and compel the recapitalization of weakly capitalized banks, and if necessary, to force their early resolution, either by merger with a healthier institution or closure (and thus payoff of insured depositors in full, and other creditors based on the recoverable assets).¹⁰ The FDIC may protect uninsured depositors and creditors, however, if key federal authorities determine that such action is necessary to prevent systemic risk.¹¹

The financial crisis has revealed, however, the weaknesses in having no clear procedures for handling the resolution of a non-bank LCFI. Federal regulators were forced into making decisions about whether to bail out creditors of well-known large banks over a few days or a weekend because they believed that current bankruptcy procedures were too cumbersome and time-

¹⁰ The Task Force takes note of the fact that the FDIC has suffered significant losses, on average, on the banks that it has resolved during the course of the crisis. Going forward, the Task Force urges the FDIC to work closely with the appropriate bank regulators (or the NFR, as suggested in the *Principles* statement) to intervene earlier with weak banks to avoid such losses in the future and to be more consistent with the spirit and letter of the prompt corrective action provisions of FDICIA.

¹¹ Under FDICIA, this "systemic risk" exception may be invoked only by the the President, upon an affirmative recommendation by the Secretary of the Treasury, a majority of the members of the Federal Reserve Board, and the majority of the board of the FDIC.

consuming. Meanwhile, there was no bank-like administrative resolution process for non-bank LCFIs.

The Task Force firmly believes that going forward it is essential for all LCFIs to be able to fail without unacceptably high costs to taxpayers or the rest of the financial system. Future arrangements for resolving non-depository LCFIs must be far more predictable to reduce moral hazard in advance and uncertainty when failure appears imminent. At the same time, future failures should not be allowed to cause contagion and threaten the stability of the system as a whole.

The *Principles* statement reflects the view that the best way to accomplish these objectives is through a *hybrid solution* – with a strengthened bankruptcy process as the default resolution procedure for all non-bank financial institutions, and a backstop, bank-like administrative resolution process in exceptional circumstances when stringent tests are met.

A Strengthened Bankruptcy Process for Failed Non-Depositories

The Task Force urges the creation of a new Federal Financial Institutions Bankruptcy Court (FFIBC) which should be granted sole jurisdiction in the United States for the resolution of failing non-depository financial institutions. The bankruptcy code should be amended as necessary so that bankruptcy can be the default process for managing all failing non-depository financial institutions.

There is a difference of views within the Task Force regarding the tests that should be satisfied before the preferred bankruptcy process should yield to the administrative resolution process described next. Some want more stringent conditions; others advocate a more lenient test.

For example, those advocating the more stringent conditions would require that the Administration apply for and receive a Congressional appropriation before a bankruptcy can be converted to an administrative process. In the interim, the firm in question would enter the bankruptcy process in the proposed special-purpose bankruptcy court. Congress would then have a limited and fixed number of days in which to make such an appropriation. A customary stay would apply, and the Fed could provide sufficient debtor-in-possession (DIP) financing against collateral under its powers granted by Section 13(3) of the Federal Reserve Act, to permit the firm to continue to operate while Congress deliberated. If Congress appropriated, then the estate of the firm could be transferred to the administrative procedure. If Congress chose not to provide an appropriation, then the bankruptcy process would continue and the Fed would exercise its collateral once circumstances permitted.

Other Task Force members believe that stringent conditions for administrative resolution like those just outlined would be easily avoided in a future crisis on anything like the scale of the most recent one, and for this reason would not be viewed as credible by key market participants, notably the creditors of LCFIs. Accordingly, these members advocate more lenient conditions for transferring a failing non-bank into an administrative resolution. For example, Congress could require consultation and formal agreement between the Treasury and the concerned federal financial regulatory agencies that would permit (more effectively applied) bank-like prompt corrective action (PCA) procedures to be applied to a resolution of any non-depository financial institutions without waiting for a bankruptcy. Under this approach, the

designated administrative resolution authority – which the Task Force recommends to be the NFR under any set of conditions – would be able to intervene on any scale that was necessary under the circumstances (If PCA were implemented as it was originally designed for banks – so a federal takeover could proceed while the institution still had some minimal value -- this would limit or even conceivably eliminate altogether the costs of federal intervention).

Aside from establishing a specialized bankruptcy process for failed non-depository financial institutions, the Task Force also recommends a more general reform of the bankruptcy laws to address a perverse situation enabled by the creation of credit default swaps. We discuss this matter in a later section. **[Note to the Members of the Task Force: we discussed this idea, fleshed out below, but did not include it in the *Principles* Statement. However, since there appeared to be general support for addressing this particular problem, some draft language is included here and elsewhere in this expanded report]**

A Backstop Administrative Resolution Process for Failed Non-Depositories

Regardless of the nature and severity of conditions for triggering it, the Task Force also urges the creation of a new administrative resolution process for failing non-depository financial institutions, for use only in those exceptional occasions when a bankruptcy poses unacceptable systemic risks. Once the conditions for invoking the process are met, the resolution authority – ideally the newly created NFR -- should have broad powers to manage failing non-depository financial institutions. The objective of resolution should be to minimize overall costs to the economy rather than to protect any class of creditors.

The NFR, as administrator, should submit a detailed and timely report to the Congress on the causes and consequences of any non-bank financial institutions resolved under its jurisdiction. Among other things, the report should cover any regulatory failures and document the reasons why the administrative resolution process was used.

Any taxpayer costs of resolution should be recovered from the financial services industry on *ex post* basis once conditions permit. This will create an incentive among institutions to disseminate best practices on the one hand and, on the other, to argue against any administrative resolutions that might in fact be unnecessary. The Task Force rejected an *ex ante* assessment mechanism (even one with temporary borrowing from the Treasury to bridge any funding shortfalls, repaid by a supplemental *ex post* assessment) primarily because this could make it easier and more tempting for policy makers to use the administrative resolution process.

The Task Force debated various options for the assessment base, but did not decide among them. One approach would be to assess only non-bank LCFIs, but this would require identifying such institutions in advance, a step that the Task Force rejected in deciding how to apply the progressively stronger capital, liquidity and leverage requirements. At the other extreme, one could assess all non-bank financial institutions, perhaps in proportion to their assets. This step, however, would impose costs on many smaller financial institutions whose creditors would never receive more favorable treatment (even absent full protection) because these institutions are not large or complex enough ever to be considered systemically important.

General Provisions

However a non-bank financial institution is resolved – whether through the strengthened bankruptcy process or the new administrative mechanism – shareholders in a failing non-depository financial institution (bank or non-bank) should lose their investment, senior management responsible for the institutional failure should lose their jobs and all unsecured creditors (including subordinated debt holders) should face a haircut.

In short, no institution should be “too big to fail”. With a policy in place, moral hazard and its attendant distortions to the market and public costs will be significantly reduced.

Breakup or Shrinkage

The Task Force considered the seemingly straightforward notion that one way to end “too big to fail” is to *preemptively* force the shrinkage of all financial institutions – bank or non-bank – to a size below some threshold, and to maintain the institutions below that size level.¹² By definition, the size threshold would be the maximum size at which an institution could operate without, under any circumstances, be considered too big to fail. On January 21, 2010, the President endorsed this idea, along with a proposal to ban commercial banks with insured deposits from engaging in “proprietary trading.”¹³

Although an absolute size limit is understandably tempting, the Task Force does not support the idea for several reasons:

First, there is no established or principled way to set the size limitation, other than on a purely arbitrary basis.

Second, any size limit could have perverse effects. Because a limit would eliminate rewards from asset growth, it could discourage managers of affected institutions from maximizing profits, and thus diminish innovation and competition in financial services markets.¹⁴

Third, a size limit for financial institutions applied to the U.S. operations of financial institutions would encourage them to move their activities or book their funding and assets in foreign affiliates or subsidiaries. In theory, such moves to circumvent a U.S. limitation could be offset by applying the limit to the consolidated operations of companies. But entities could evade even this rule by limiting their ownership of foreign affiliates/subsidiaries to levels that would not require consolidation (under applicable accounting rules or under any special statutory rules established for this purposes).

Fourth, a related problem with a size limit on the consolidated activities of entities doing business in the United States is that it would provide artificial competitive advantages in global

¹² By the same logic, non-financial institutions subject to bailouts for political reasons (such as auto companies, but not limited to them) also should be forced to stay below some size threshold. Although the Task Force did not consider this idea, the same reasons counseling against preemptive size limitations of financial institutions described in the text would apply to size restrictions on non-financial firms.

¹³ The *Principles* statement did not address the issue of whether banks should be prohibited or limited in their proprietary trading activities. The Task Force may issue or commission a separate paper on this topic.

¹⁴ The Task Force discussed whether a size limit would also reduce economies of scale and scope in financial services. Several members noted that the existing empirical literature on scale and scope economies does not provide firm guidance on this question.

activities outside the United States to foreign financial institutions not subject to this limit. Furthermore, a U.S.-centered size limit (depending on how it was constructed or defined) could inhibit or even prevent foreign financial institutions from doing business in the United States, reducing competition for financial services in the United States and leading to frictions with other governments.¹⁵

Fifth, a size limitation does not deal with excessive corporate complexity (especially for internationally-active financial institutions), which can also make it difficult to quickly resolve failed institutions and thus tempt policy makers to resort to administrative resolution. As discussed shortly, complexity is difficult, if not impossible, to define with precision in a statute, and is thus better addressed on a case-by-case basis.

For all these reasons, the Task Force does not favor an absolute size limit as the way to end TBTF. Instead, the *Principles* Statement prefers the multi-pronged approach outlined in that document and elaborated further here: by effectively “taxing” financial institutions as their size increases with progressively tougher regulatory requirements; by requiring institutions above some size threshold to prepare and obtain regulatory approval for wind-up plans; and by implementing a hybrid resolution system that will always impose some haircut on all unsecured creditors.

Yet, as noted earlier, the concept of forced shrinkage is contained in the wind-up plan requirement, but is recommended only on a case-by-case basis and not across-the-board as an absolute limit on all financial institutions. Administered this way, forced shrinkage is a penalty for excessive complexity, illiquidity, or some other aspect of an institution’s business that makes it especially dangerous to the health of other financial institutions and the entire financial system and has not been adequately planned for in case the institution nears failure. This case-by-case approach avoids the disincentives for innovation and competitiveness that would be entailed in an absolute size limit. We believe the approach recommended here removes incentives for appropriately managed large institutions to move off-shore, as well as potential frictions with other governments, that are also problematic features of a size limit imposed only by the United States.

Summary

In summary, the signatories of the *Principles* Statement recommend the following measures to deal with large, complex financial institutions and thus to end “too big to fail.”

The larger and more complex an institution, the higher the standards for capital, liquidity and leverage to which it should be held. Large institutions should maintain regulator-approved wind-up plans and, if they cannot, they should be required to shrink. No institutions, however large or complex, should be “too big to fail.” Depository institution failures should continue to be handled by the FDIC. A hybrid solution should be adopted

¹⁵ The Task Force did not discuss whether size limits would thus contravene commitments made by the United States to refrain from restrictions on foreign direct investment under any of its obligations under existing trade and investment agreements with other countries. This is clearly an issue that requires further study. Of course, any conflict with existing trade or investment agreements could be removed if all major nations, such as the G-20, adopted the same size restrictions. But this seems highly unlikely given the different sizes of these economies and their current financial institutions.

for non-depository financial institutions comprising a strengthened bankruptcy process as the default approach and a backstop administrative resolution process, available in exceptional circumstances after strong safeguards have been met. In all circumstances, shareholders in a failing institution should lose their investment, senior management responsible for the institutional failure should lose their jobs, and unsecured creditors should face a haircut.

Micro-prudential Regulation and Consolidation

While federal and state financial supervisors failed to prevent the excessive risk-taking by the institutions under their watch that helped lead to the financial crisis, the Task Force believes that the current patchwork of federal financial regulatory agencies and their jurisdictions that long pre-dated the crisis also enabled certain institutions to take advantage of the fragmentation, to the detriment of the financial system as a whole.

It is true, of course, that a system of competitive regulators can keep the financial system from becoming sclerotic. A single regulator for all financial institutions, for example, has no incentive to correct its errors, while the institutions under its watch have nowhere else to go – except abroad – to escape them.

At the same time, however, a system that allows institutions too much ability to shop charters and thus regulatory oversight, also can permit a “race to the bottom” that enables institutions to take excessive risks that put the entire financial system at risk. The case of AIG’s infamous credit default swap (CDS) operations is a case in point. AIG failed because the parent company was able to choose a regulator (the Office of Thrift Supervision) that had little experience with the CDS market, which enabled the company to write CDS contracts in volumes that exceeded the company’s ability to honor them.¹⁶ None of the state regulators of the company’s insurance operations, carried out through subsidiaries of the parent, had the authority to prevent this abuse of financial power.¹⁷

Furthermore, excessive competition among regulators can lead agencies to adopt inconsistent rules, and may also contribute to an atmosphere in which relevant policy makers have insufficient incentives to provide adequate resources for examining and supervising individual financial institutions (With multiple regulators in charge, efforts to add more resources for each one can more easily be represented to be excessive regulation).

The *Principles* Statement reflects the view that the perils of both too many and too few regulators can and should be avoided by a middle path that preserves the dual banking system – banks can retain a choice between a state or federal charter – while consolidating existing

¹⁶ AIG was regulated by the OTS as a unitary thrift holding company, since the parent company owned a single thrift institution along with its insurance subsidiaries.

¹⁷ The company’s state regulators also failed to prevent the insurance subsidiaries from investing funds temporarily obtained from lending securities to securities firms in risky assets, such as complex mortgage-backed securities.

federal regulatory authorities over financial institutions in a single micro-prudential regulator. That regulator should be the newly created National Financial Regulator (NFR).

The Roles of the NFR

As envisioned in the *Principles* Statement, the NFR should provide prudential supervision and regulation of all federally chartered or insured financial intermediaries, including both commercial and investment banks and their holding companies. As a practical matter, this means that the NFR would combine the Office of the Comptroller of the Currency (OCC), the OTS and the FDIC, and would also take on all of the current micro-prudential (safety and soundness) responsibilities of the Fed, the SEC, the CFTC and the Federal Housing Finance Agency (FHFA), assuming that Fannie Mae and Freddie Mac (the housing government-sponsored enterprises) continue to exist in some form. The Chairman of the NFR should be nominated by the President and confirmed by the Senate.

The NFR proposal, as outlined in the *Principles* Statement, would also have the following additional features:

--The NFR should be organized into divisions to accommodate the different types of financial institutions from the smallest community bank to the largest international conglomerate. In addition, the internal organization of the NFR should change as the nature of the institutions under supervision and their activities change. Such regulatory adaptation should be easier to accomplish than under the current fragmented system under which different agencies oversee the prudential regulation of institutions with different charters.

--The NFR should set and enforce micro-prudential standards for capital, leverage and liquidity and should also enforce any higher-than-normal standards set by the FSOC for macro-prudential reasons. The SEC and the CFTC should continue to jointly oversee securities and derivatives activities. These two agencies should enforce any market leverage premia proposed by the Fed and agreed to by the FSOC for macro-prudential reasons.

--The FDIC brand should be maintained. Administration of the Deposit Insurance Fund and resolution responsibilities of the FDIC should be assigned to a separate NFR division. If the FDIC's board were retained (there may be efficiency reasons not to do so), its board membership could be changed to be the same as the NFR board membership and the chairmanships of the NFR and the FDIC could be combined. The FDIC's examination and supervision functions should become a part of the larger examination and supervision functions of the NFR.

The NFR would concentrate expertise, promote professionalism, eliminate current gaps and inconsistencies, reduce regulatory burdens, prevent charter shopping, and reduce the risk of regulatory capture. The legislation creating the NFR should enable future financial regulation to allow for and follow the evolution of the financial system and the institutions that make it up. Like institutions should be subject to like regulation. As an institution changes character, there should be no regulatory barriers to corresponding changes in the manner in which it is regulated.

The Roles of the Fed

The NFR proposal to move the Fed's current oversight and examination authority – over roughly 1,000 state-chartered banks and all bank and financial holding companies – to the NFR admittedly is controversial. The Task Force discussed this issue extensively. Not all of the members agreed with the proposal to transfer these responsibilities from the Fed. However, a clear majority of the Task Force members who signed the *Principles Statement* did support the idea, for several reasons.

First, although all federal banking regulators clearly failed in their oversight responsibilities, the Fed's shortcomings are especially worrisome because it has examination and supervisory authority over the nation's largest financial organizations: bank and financial holding companies. It is these institutions that not only played a central role in the underwriting and holding of complex mortgage securities that in retrospect never should have been formed and sold, but also because of their size and/or complexity, these institutions were most likely to be beneficiaries of the various government rescue initiatives.

Second, going forward, it is clear and necessary that the Fed will have a central role – either on its own or, as the *Principles Statement* and others in Congress have recommended, as a key player on the FSOC – in monitoring systemic risk and suggesting measures to mitigate it. This critical role will be added to the Fed's ongoing monetary policy and lender-of-last resort responsibilities. The question then naturally arises: given the past supervisory failures of the Fed and its multiple current and future responsibilities, does it have a comparative advantage in also retaining its supervisory and examination responsibility for individual financial institutions (as well as its current responsibilities for consumer protection, an issue we take up next)? The signatories of the *Principles Statement* believe that the answer to this question is “no.”

Third, this conclusion is reinforced by the increased potential for conflicts between functions if the Fed were to retain its supervisory functions while also gaining new responsibilities for monitoring systemic risk (either on its own or as a key member of the KFSOC). As discussed earlier in our first section, any body (not just the Fed) that has both specific examination authority and oversight responsibility for systemic risk may be tempted to compromise one objective in pursuit of the other. For example, any warning of heightened systemic risk, by depressing asset values, could contribute to the deterioration of the balance sheets of key financial institutions. If the agency charged with providing such warnings also has responsibility for overseeing the financial condition of the individual institutions whose financial health could be affected by those warnings, the agency could be tempted to hesitate or not issue warnings of growing systemic risk when objective conditions would warrant doing so. The Fed would be put in such a position if it were thus to retain both micro-prudential and macro-prudential responsibilities.¹⁸

¹⁸ Arguably, the Fed all along has had the same potential conflict between its supervisory and monetary policy functions as well. A more restrictive monetary policy aimed at fighting inflation also can impair the financial health of financial institutions under the Fed's watch, and for this reason, a deserved tightening of monetary policy could be delayed. Conversely, the Fed may pursue a more liberal monetary policy than it otherwise would knowing that in doing so it could help strengthen the financial condition of the institutions under its watch. The proposal in the *Principles Statement* to replace the Fed's micro-

Fourth, and perhaps most important, limiting the range of the Fed's responsibilities is more likely to enhance than detract from the Fed's independence in conducting its other functions, especially monetary policy. The Task Force notes with concern the recent efforts in Congress to constrain or second-guess the Fed's monetary policy actions. These efforts run counter to the overwhelming empirical evidence that central bank independence makes monetary policy more effective in containing inflation because it helps convince private sector participants in asset and good markets that an independent central bank will be less likely to print money to finance public sector deficits. The best way for the Fed to avoid the current and future threats to its independence is to stick to jobs that it is in the best position to carry out, notably monetary policy, lending as a last resort, and macro-prudential regulation. The Fed that is out of the business of supervising and examining individual financial institutions, however large or complex they may be, will be a more effective and independent central bank.

The signatories of the *Principles* Statement nonetheless recognize that there is an opposing view, namely that it is essential for the Fed to have detailed and timely knowledge of the financial condition of individual financial institutions in effectively carrying out all of its other responsibilities – both its current monetary policy and lender-of-last-resort functions and any new responsibilities with respect to monitoring systemic risk. The signatories believe, however, that this view can be accommodated by enabling the Fed staff to attend any and all examinations of individual institutions they desire, and for the Fed to require collection of any data not now collected by any other financial regulatory body, to better enable it to carry out monetary policy and to monitor systemic risk. Any such additional data that are collected should be shared in their entirety and as promptly as feasible with other agency members of the FSOC.

Substantive Prudential Regulation Going Forward

Regardless of how financial regulation is structured among the agencies, the financial crisis has underscored that the *substance* of prudential regulation must be improved. The *Principles* Statement endorsed the following specific ways of doing this.

--Capital standards should be significantly increased, but phased in to accommodate the recovery. While it is true that capital can dissipate quickly, it remains the main buffer not only against individual institutional failure but also against contagion among institutions. While reported levels of capital based on historic valuations of assets and liabilities may have been high in some institutions that failed during the recent crisis, they proved to be misleading indicators of capital strength.

--Larger banks and banking organizations that are capable of accessing the capital markets should issue a minimum amount of subordinated debt that converts to equity in times of stress.¹⁹ The conversion feature not only automatically provides additional capital precisely

prudential authority with new responsibilities for macro-prudential oversight would address these potential conflicts as well.

¹⁹ The "triggers" for such conversion can either be automatic (and thus tied to some market-based measure, such as the institution's stock price or the price on its credit default swaps) or discretionary, based on a regulatory assessment of the institution's capital position. There are merits and drawbacks to

when an institution needs it, but also ensures that subordinated debt holders will be put at risk and not bailed out, even if the authorities guarantee other creditors to prevent systemic risk. In suitable amounts, the value of such “contingent capital” to the institution and to the financial system during a future crisis should justify any premium the market may demand relative to conventional debt.

--New standards for liquidity management should be introduced for all financial intermediaries. A financial institution that depends heavily on short-term borrowing is at risk compared to one with more stable sources of funding. Liquidity standards should require that a sufficient buffer of liquid assets be maintained over and above the immediate short-term obligations of an institution so that it can continue to operate even if its access to money markets is denied for a sustained period. The liquidity standards should give most weight to cash and U.S. Treasury securities on the asset side because these assets proved to be liquid during the crisis. Beyond that, sources of liquidity should be sufficiently diversified to offer protection in times of distress for particular liquidity providers or money markets.

--In the future, financial regulation should focus on risk governance and management as much as measurement. There is room for more useful discussion and understanding of the nature of different risks and their management both within boards and between senior management and regulators.

--Examinations should be strengthened and their quality improved. There should be less focus on process and more on risk-taking and outcomes. Examinations must be more forward looking if they are to help as much as they should in guaranteeing the safety and soundness of the institutions involved. Something like the recent stress tests for the largest institutions should be implemented as a permanent feature of the regulatory and examination process.

--Examination teams should be further professionalized through a combination of better selection, recruitment, training and compensation practices. Examiners should be held accountable for outcomes. Higher standards should be required for risk management qualifications, governance, oversight and effectiveness in financial institutions.

--Finally, as we have discussed earlier, no financial institutions should be pre-designated as systemically significant or, on that basis, assigned for special oversight to another agency such as the Fed. Such an arrangement would entrench differences and potentially perpetuate moral hazard.

Summary

The following summary captures the main recommendations in the *Principles* Statement for improving micro-prudential regulation of financial institutions.

either approach. A virtue of an automatic trigger is that the conversion cannot be subject to regulatory delay; a potential drawback, however, is that sophisticated investors may be able to induce a conversion (for example, by heavily purchasing CDS contracts) and then profiting from it (by shorting the stock). A discretionary trigger avoids potential “market gaming,” but is subject to the arbitrary decisions by regulators. While the Task Force considered these issues, it did not decide which type of trigger should be used (nor what measure to which the trigger should be tied).

A new National Financial Regulator (NFR) for safety and soundness regulation should be created by combining the OCC, the OTS and the FDIC, and assuming all of the current micro-prudential responsibilities of the Fed, the SEC, the CFTC and the FHFA. Within the NFR, the FDIC should retain distinct roles for resolution and the deposit insurance fund. Capital standards should be significantly increased. Banks should issue debt that converts to equity in times of stress. Strong liquidity standards should be introduced. Regulation should focus on risk governance and management as much as measurement. Examinations should be strengthened. No institutions should be pre-designated as deserving of special regulatory treatment.

Strengthening Markets and Market Discipline

Better regulation alone cannot be counted on to insulate the financial system and the wider economy from future financial crises. Regulators, even after they have improved in the wake of the crisis with the help of new tools and experience, are still human beings. People make mistakes, and so will future policy makers.

Regulators can therefore benefit hugely from well-functioning markets. Market signals reflect the “wisdom of crowds” that often (but not always) proves more accurate than the insights or projections of even the most experienced and talented individuals or groups of individuals. When markets perform well, they steer firms and individuals toward productive activities, and penalize excessive risk-taking.

But market discipline can work only if it is permitted to work. Despite the various rescues of individual firms and/or their creditors during the financial crisis, market discipline is not dead. Certainly smaller firms – too small to merit federal rescue – understand this. A key challenge for policy makers going forward is to ensure that larger firms and all of their stakeholders understand this as well.

The suggestions outlined earlier for ending TBTF, if adopted, will mark a significant step toward strengthening market discipline. In this section, we outline several additional ways to accomplish this important objective.

Over-The-Counter (OTC) Derivatives Markets

Several years ago, few Americans (or citizens of other countries, for that matter) outside of those working in or highly familiar with finance had heard of the word “derivatives”, let alone one of its manifestations, “credit default swap.” Now, both words have entered the popular lexicon, although both are still not well understood.

Formally speaking, a “derivative” financial instrument is one whose value is “derived” from the value of some “underlying” asset. For example, futures contracts on commodities have been available since the 1700s, giving both sellers (such as farmers) and buyers (such as food processors or retailers) certainty about the price at which will transact at some later date. This future price is clearly dependent on the “spot” price of the commodity, or the price of it today,

but may (and almost certainly will) vary on account of market expectations of supply and demand in the future, the cost of money, and perhaps other variables.

Today, futures contracts for a wide range of commodities and a variety of financial measures (notably interest rates and the values of different currencies and stock or bond indexes) are traded on exchanges in the United States and elsewhere around the world. So are options, which are close cousins of future contracts, but differ in several respects.²⁰

In recent decades, a whole new genre of less standardized derivatives have been designed by financial institutions to meet the customized needs for hedging by a wide range of both financial and non-financial corporations. In particular, “swap” arrangements of various kinds, whose value is tied to some underlying asset or financial measure, have exploded in volume. The principle examples are interest-rate swaps (in which the parties swap different kinds of payment streams, such as fixed for variable, or vice versa) and currency swaps (in which case the parties exchange payment streams denominated in different currencies). Other common swap agreements are tied to the price of various commodities, especially oil, or to individual stocks or groups of them (notably various stock indexes).

The most recently developed -- and in the wake of the financial crisis the most controversial -- swaps are “credit default swaps” (CDS), in which the buyer makes regular payments to the seller, who pays the amount of the CDS if the issuer of the referenced obligation (such as a bond or a loan) defaults. When a holder of the obligation purchases the CDS, the instrument is functionally equivalent to buying insurance against default. However, dealers may and do sell CDS to buyers who have no interest in the underlying obligation, but instead want to “speculate” on whether it will enter into default, or what is probably equally true, on what others believe to be the likelihood of default (which will be reflected in the price of the CDS).

Since the financial crisis, CDS instruments have attracted attention among policy makers, the media and the wider public for several reasons:

--Many issuers of CDOs purchased CDS to provide financial protection to the buyers of one or tranches of the CDO securities, as a way of convincing the rating agencies to assign higher ratings than they otherwise would. Investors in CDOs, such as hedge funds, bought CDS to hedge their risks.²¹ On one view, therefore, CDOs could not have been sold, and thus many of

²⁰ Unlike futures contracts which require settlement in cash or delivery of the underlying commodity or instrument on the settlement date, options give their holders the right to buy (a “call”) or sell (a “put”) a commodity or financial instrument at a certain price (the “strike price”) at any time before the option expires. As the name implies, the holder of the option does not have to exercise it (and will do so only if the market price makes it worthwhile to do so). For this reason, the buyer of the option only has the amount paid for it at risk, whereas the buyer and seller of the futures contract is obligated in full unless the position is reversed (the buyer sells the contract before it expires, or the seller buys it back before then).

²¹ CDO issuers and purchasers also bought default insurance sold by the traditional monoline bond insurers for the same reasons.

the underlying subprime mortgages that secured them could not have been originated, without the development of the CDS market. An alternative view is that the CDS market developed in response to a clear and legitimate market demand for the financial protection these instruments offered: CDO issuers and buyers understandably wanted to reduce their risks when buying securities that were backed by risky assets.

--The most publicized of CDS was by AIG, which eventually sold roughly \$400 billion of these instruments to various financial institutions and other parties. As is common with CDS contracts, AIG as an issuer was obliged to come up with additional collateral if its credit rating fell, which happened in the wake of the general mortgage market turmoil in September, 2008 and specifically after the collapse of Lehman Brothers. Because AIG did not have the \$100+ billion that was required to provide such additional collateral, it was unable to honor its CDS contracts. The Federal Reserve stepped in to rescue the firm for several reasons, one of which was a concern that a failure by AIG to honor its CDS obligations could trigger a cascade of losses among its many counterparties, adding significant stress to financial markets (especially the inter-bank lending market) that were already heavily stressed.

--The explosive growth in CDS contracts -- which reached at peak of over \$60 trillion in "notional value" worldwide before the crisis -- has prompted concerns that other issuers may be like AIG and unable in the future to honor their contracts in times of financial stress, and thus possibly lead to systemic risks. Special attention has been given to the purchase of CDS contracts by "speculators" -- those who have no economic interest in the underlying obligation to which the CDS refers -- who have contributed to the growth in CDS volume, and thus are blamed by some for aggravating systemic risk.

The Task Force was not in a position to investigate the merits of concerns by the Fed and private sector participants at the time of the AIG rescue about the systemic threat posed by the company's failure through the CDS market. Instead, we simply took note that such fears were widespread at the time, and that several features of that market very likely contributed to them. Several policy responses to modify those features therefore are appropriate.

Clearinghouses: First, and perhaps most important, prior to the crisis there was no central clearinghouse for CDS contracts (although certain activity traded derivatives, interest rate swaps and some energy derivatives, have been and continue to centrally cleared). Without a clearinghouse, purchasers of a CDS contract must look only to the sellers to be paid. Thus, if a seller fails or its collateral is insufficient, purchasers could suffer losses (especially if the collateral is liquidated at a time when markets for it are thin). As noted, the fear of systemic risk centers on the concern that the failure of a large financial institution with a large exposure in derivatives markets could cause losses of such magnitude to other counterparties that the collective adverse impact on the financial system as a whole would be systemically significant.

The *Principles Statement* outlined two remedies for this problem. *One useful step is for regulators to require that collateral be held and managed by third parties rather than by the sellers.* This is how the "tri-party repurchase (repo)" market currently works, and while this market too requires some institutional improvements, purchasers are likely to gain control of

any collateral, should they need to, more quickly and more reliably if the collateral is held by a third party.²²

A more fundamental reform is for regulators to induce sellers and buyers of CDS contracts -- and indeed counter-parties to all OTC derivatives -- to migrate their transactions onto clearing houses and eventually onto exchanges. When a derivatives contract or instrument is centrally cleared, the counterparty for each is the clearinghouse. Provided the clearinghouse is well capitalized and has adequate arrangements for loss sharing – conditions that regulators must assure and enforce – then parties to a derivative contract, such as a CDS, are not at risk if their counterparties fail to perform, and thus in principle any systemic risk arising from these events is substantially reduced, if not eliminated. Of course, to protect itself against default by derivatives counterparties, a clearinghouse will require the counterparties dealing with it to post adequate collateral and to maintain appropriate capital cushions.

The Task Force considered whether parties to OTC derivatives contracts should be required or induced to clear centrally. Any requirement would oblige a regulatory body to decide what contracts are sufficiently standardized so as to be amenable to central clearing (leaving customized contracts to be dealt with separately, either by regulation or the market). This is a more difficult task than it may appear, and regulatory decision-making runs the risk of stifling innovation in derivatives to the detriment of parties that need or want customized instruments to hedge certain risks. Thus, regulators may declare that a contract is sufficiently standardized to be subject to central clearing, only to discover that no parties then want to use that contract or that any clearinghouse is willing to accept it for clearing.

For this reason, the Task Force favors an approach that would *induce* derivatives users to clear centrally and thus harness market forces to effectively decide which contracts should be cleared in this manner. A ready way to do this is for regulators to impose higher capital requirements on derivatives that are *not centrally cleared and/or traded on exchanges*.²³ In effect, this would effectively tax derivatives that are customized and thus not cleared centrally (because such instruments would be more expensive to finance than standardized contracts). The “tax”, or the higher capital charge, would represent a charge for the externality that non-standard derivatives impose on the rest of the financial system.²⁴

²² Repurchase agreements involve the sale of securities with an obligation to repurchase them on a set date and at a set price.

²³ Financial instruments that are traded on exchanges are also automatically, as a practical matter, cleared centrally. In contrast, a financial instrument may be cleared centrally but not yet traded on an exchange. Central clearing, however, is likely to be precursor to exchange trading.

²⁴ The Task Force discussed the issue of whether policy should favor or discourage the formation of multiple clearinghouses within the United States (already a number of clearinghouses for OTC derivatives transactions abroad have been formed or encouraged by their governments). On the one hand, more clearinghouses would promote competition in clearing, which should reduce clearing prices and encourage innovation. On the other hand, having all clearing done by a single clearinghouse would permit the maximum degree of “netting” -- the offsetting of obligations of one contract with another for the same parties – which reduces systemic risk. This is especially important if the clearinghouse clears different kinds of contracts (which expand the opportunities for netting). If operationally and legally it can be accomplished at reasonable cost, netting across multiple clearinghouses would produce the best of all worlds, gaining the advantage of competition while reducing the net exposures of the various counterparties, thus reducing systemic risk.

Trade Registries: Second, one of the sources of systemic risk in the run-up to the crisis was the increasing backlog in derivatives trades that went unrecorded for significant periods of time, which made it difficult for participants in OTC derivatives markets to know their true exposures at any one time. In 2005, at the behest of the bank supervisors of the largest OTC derivatives dealers, the key market participants created a central depository in 2008 at the Depository Trust Clearing Corporation (DTCC) to log all credit derivatives trades. This step substantially reduced the backlog in these instruments, and almost certainly reduced the fallout of the Lehman Brothers failure. At the current writing, efforts are underway to record other derivatives in this central depository.²⁵

The Task Force recognizes and applauds these steps. The *Principles* statement urges one further, more formal step: that Congress actually *require* OTC derivatives transactions that are not cleared centrally to be registered with trade registries. This requirement should be enforced by either the SEC or the CFTC.

CDS and the Bankruptcy Process: [This is the provisional language hinted at earlier] Third, one unusual – and we believe perverse – outcome of the development of the CDS market is that holders of CDS contracts can be in a position to abuse the bankruptcy process. Because a CDS contract, by definition, only pays the holder if the referenced obligation is in default, clever arbitrageurs can buy CDS contracts of financially troubled companies and thus hope, and if they have sufficient clout (by themselves or in concert with others) can push, those companies into bankruptcy precisely so that they can collect on their contracts. Potential abuses of this type can and should be limited by limiting creditors' voting power in any approving any bankruptcy plan to their net positions – gross amount of their lending minus any amount covered by a CDS contract or its functional equivalent.

Caution: In recommending its reforms, the signatories of the *Principles* Statement – and indeed all of the Task Force members – strongly believe that the CDS market remains valuable and so do the instruments themselves. Any reforms that are adopted to reduce any systemic threats posed by CDS or any other financial derivatives should not detract from these benefits.

In particular, CDS contracts provide useful signals of the likelihood of future financial difficulty on the part of the referenced issuer that bond prices or equities markets do not and cannot capture. Trading in an issuer's bonds is likely to be thinner than that on its CDS contracts; furthermore, CDS contracts may cover obligations other than bonds that are not frequently traded. Meanwhile, although a company's stock is likely to be traded in more liquid markets than its bonds, because stockholders benefit from the upside in a company's performance and thus not only care about its downside, they are likely to be less risk averse than either

²⁵ A number of other improvements in derivatives markets have also been implemented. These are described in Darrell Duffie, Ada Li, and Theo Lubke, "Policy Perspectives on OTC Derivatives Market Infrastructure," Federal Reserve Bank of New York Staff Report No. 424, January, 2010, at http://www.newyorkfed.org/research/staff_reports/sr424.html

bondholders or holders of CDS positions.²⁶ Accordingly, equity prices are likely to be less sensitive to a company's potential adverse financial prospects than are the prices of CDS contracts on its debt.

CDS prices therefore provide useful signals to multiple parties: to investors, to analysts, and to the managers of the entities on which the CDS are issued. The signals can also be used by regulators as early indicators of financial stress at particular financial institutions. These are all reasons why CDS markets are important for market discipline.

With these points in mind, the Task Force cautions against the adoption of proposals that would require certain CDS purchasers also to have an underlying position in the loan or obligation to which the CDS is tied. On the surface, such a concept may be appealing, in that it seems to call for prohibiting the purchase of insurance unless one actually owns the item insured, such as a house or a building. On such a theory, so-called "speculative" purchases of loan default insurance would thus be made unlawful.

Yet as already noted, speculative buyers of CDS contracts are no different than buyers of many other types of derivatives, such as futures and options, who have no economic interest in the underlying asset. Indeed, without "speculators," markets for derivatives – and all other types of traded financial instruments such as stocks and bonds – would be far less liquid and thus far less useful institutions for hedging and signaling prices. Indeed, in many instances, without speculators there would no one to take the other side of the risks from those who want to hedge against them.

Improving Securitization

One of the major fallouts from the financial crisis is the significant interruption in the securitization market generally, not just for the exotic mortgage securities that triggered the crisis. Perhaps the best evidence for this is that the Fed has provided various facilities for financing the purchase of standard mortgage-backed securities (those guaranteed by Fannie Mae and Freddie Mac, and thus now because of their conservatorship, directly by U.S. taxpayers), as well as other asset-backed securities (those secured by consumer loans, auto loans, and commercial loans). Because the "originate-to-distribute" (OTD) model of lending had become so well entrenched in the U.S. financial system prior to the crisis, lending markets of all kinds are not likely to return to some level of normalcy until some of the key flaws in the OTD model that the crisis has revealed are repaired so that investors once again have sufficient faith in securitized products to buy them.

The Task Force discussed several mechanisms for fixing securitization, including having one or more federal agencies establish new standards, as well as requirements that originators of underlying assets as well as the asset-backed securities themselves have some "skin in the game" (the House bill, for example, contains the latter requirement). Certainly skin in the game is important, and in the wake of the crisis, whether or not it is required, investors almost certainly will demand it.

²⁶ We have earlier noted a similar contrast between stockholders and buyers of subordinated debt.

But that one reform is not enough. Nor, do we believe, that given the rapid pace of innovation that used to characterize securitization is it necessary or desirable to have federal agencies, subject to lengthy notice-and-comment rulemakings, set new rules of the game.

The signatories of the *Principles Statement* believe the better approach *is for an independent Securitization Board outside of government to be established* to develop and encourage adoption of voluntary operational standards that align the incentives of all parties involved in the securitization process with the interests of final investors. Such a board should be comprised primarily of representatives of final investors, should also include buy-side managers, originators, investment banks, credit rating agencies and other parties with an interest in raising and maintaining standards in the securitization process.

In effect, the Securitization Board should develop the equivalent of a “Good Housekeeping Seal of Approval” certification program for securitizations that meet its standards, both substantive (such as any “skin in the game” standards) and operational (standards relating to how the underlying assets, such as mortgages were originated, how any due diligence by the originator and the issuer of the securities was performed, and so on). The Board would not necessarily replace the credit agencies (which we discuss next), but could establish a high benchmark against which all future securitizations would be assessed. And because investors would be playing an important role on the Board, its certifications have a reasonable chance of helping to restore investor confidence more broadly in asset-backed securities that meet the Board’s standards in the future.

The Task Force discussed but did not resolve how the Board should be initiated and organized. Perhaps the segments of the financial services industry we recommend to be included on such a Board will see it in their self-interest to initiate the idea. Failing that, the Task Force urges one or more federal agencies with authority or interest in this subject – such as the SEC and/or one or more of the federal banking regulators – to suggest the concept, or even to organize and host the initial meeting, and then leave the subsequent activity to the newly formed Board members themselves.

Credit Ratings Agency Reform

The credit rating agencies have been widely criticized, and deservedly so, for helping to lay the foundation for the financial crisis. At best, they extrapolated from limited historical data on mortgage defaults by households with less-than-prime credit scores from years of rising house prices to a much larger volume of such mortgages on the assumption (later proved wrong) that housing prices would continue to rise or at least not fall nationwide. Moreover, in the last few years before the housing bubble popped, the ratings agencies apparently did not take adequate account of the increasing numbers of mortgages that were poorly underwritten without verification of the borrowers’ income (and thus ability to repay) and were taken out by borrowers who had put little or no equity into their home purchases. Furthermore, the agencies used the same letter grading system they had were used to applying to other credit instruments, inducing investors to believe that the default probability and/or losses-given-default for the complex securities backed by subprime and Alt-A mortgages were similar or identical to what

one would expect of bonds issued by corporations or governments, when this clearly was not the case.²⁷

In principle, the ideal reform that would address some or all of these problems would be one that changed the current issuer-pays model for ratings, which has inherent conflicts of interest because the issuers pay the agencies to rate their securities, to the agencies' original business model in which investors paid for ratings information. Technology and rapid means of communication rendered the initial business unprofitable, however, by enabling investors and analysts to learn of the ratings almost instantaneously (especially in the age of the Internet) without having to pay for them. The Task Force expresses hope that market forces will be able to get around this "free rider" problem so that either the current agencies or a new industry of credit analysts will be able profitably to charge investors or anyone else other than the issuer for credit assessments. But we have not identified any obvious public policy tool or initiative to accelerate this process.

The Task Force considered a wide range of other ideas for reforming the credit ratings process, assuming that the issuer-pays business model remains in some form. We do not believe, however, that there is any single "silver bullet" solution to the problems with credit rating agencies due, in large part, to the issuer-pays business model. Instead, a series of various reforms stand a reasonable chance of improving matters even if this model persists. The *Principles* Statement outlines several of these ideas, some of which are already incorporated in the House bill: **[Note to Task Force members: there are other ideas in the House bill that we have not included, such as requiring ratings analysts to pass exams, having the SEC examine the ratings agencies once a year, and perhaps most significantly, allowing lawsuits against them. The current draft does not mention them and our reasons for not including them. We could do so if the members of the Task Force so desire.]**

--Credit rating agencies should shift from qualitative letter-grade ratings to quantitative default probability forecasts for debt issues as well as securitizations, and their performance over time should be tracked and published (if private sector entities do not emerge to do the tracking, then a government agency like the SEC could step in, but only as a last resort).

--Credit rating agencies should publish the information and assumptions they use to calculate their ratings (a variation of this is in the House bill)

--To prevent the use of inaccurate credit ratings by regulators, credit rating agencies should no longer be awarded special official status -- the Nationally Recognized Statistical Rating Organization (NRSRO) designation -- and ratings should be removed from bank minimum capital and other regulatory standards.

--Ratings agencies that egregiously and persistently underestimate default risk should be penalized (The House bill, for example, would give the SEC the authority to deregister them. Since the Task Force believes that no credit ratings agency should any longer be given official status, the use of other penalties, such as fines, should be explored).

Compensation for Executives and Risk-Takers

²⁷ The Task Force discussed the academic literature indicating that even among all of the non-mortgage related securities the rating agencies assess, the default probabilities and/or losses-given-default for securities assigned the same letter grade in fact vary across different classes of securities.

One reason so many financial institutions took so much risk in the years leading up to the crisis is that too many of their senior executives and employees were paid to do so. In particular, compensation structures that rewarded business volume or deal flow in the short run without attention to the long run performance of loans or their institutions as a whole proved to be systemically dangerous.

The Task Force thus strongly believes that the structure of compensation schemes for senior executives and other major risk-takers in financial institutions should not create incentives for excessive risk-taking. To implement this principle, the *Principles* Statement recommends that going forward very long-term restricted stock should be a significant component of financial institutions' compensation, emulating the remuneration schemes for partners in traditional financial partnerships. Furthermore, because compensation arrangements so clearly affect the way institutions behave, the *Principles* Statement recommends that financial regulators penalize institutions whose compensation structures that are persistently out of line with risk (for example, by imposing higher capital requirements on such entities, and/or higher deposit insurance premiums, as the FDIC is currently considering).²⁸

It bears emphasis that we are not recommending that regulators oversee the *amounts* of compensation. This is a job for shareholders and thus the capital markets (except in cases where the federal government retains an ownership stake in the enterprise, when it is appropriate for some federal body to have a say in both the amount of structure of all employee compensation at these institutions).

Creditor Discipline For Banks

A vital element of any plan to end "too big to fail" is to ensure that creditors of failed banks absorb at least some loss. As noted, however, FDICIA nonetheless allows the President, upon recommendation of a combination of the Treasury, FDIC and the Fed, to protect all depositors and creditors of a failing bank if not doing so would lead to systemic risk. The Task Force understands the need for a "systemic risk exception" for uninsured bank *depositors*, who can easily "run" not only from the failing institution but from other banks. The same may be true of certain short-term creditors, who may be unwilling to roll over their loans or extend new ones, not just as the failing institution but at other ones as well.

The Task Force does not believe the "run" problem holds for one kind of creditor – the holder of long-term (maturity at least one year) subordinated debt. By definition, subordinated debt is unsecured and uninsured. But unlike depositors, subordinated debt holders cannot "run", but instead must wait for their instrument to mature or, if possible, to sell the debt to someone else. This is a virtue for both the bank, since such debt does not have to be immediately repaid if the bank has a liquidity problem (and unlike dividends paid on stock, the interest on subordinated debt is tax deductible), and for society, since subordinated debt holders thus have strong incentives to monitor the institution and to discourage it from taking excessive risk.

²⁸ We take note of the fact that the Federal Reserve has already begun to implement this concept in overseeing the compensation structures of the financial institutions under its supervisory jurisdiction. If the prudential regulation of financial institutions is consolidated in the NFR or something like it, that body should be as aggressive in overseeing financial compensation structures as the Fed currently appears to be.

To those who might say that subordinated debt holders failed to exert enough discipline on the larger banks that ran into trouble during the recent financial crisis, there is a ready response: under current capital standards, no bank is *required* to issue subordinated debt. Its issuance so far has been purely voluntary.

The signatories of the *Principles* Statement believe that banks and their management would behave differently if they knew they regularly had to go to the public market and sell new subordinated debt, replace previous amounts of such debt that have matured, or to back expansion of the bank (since the debt requirement would be expressed as a percentage of bank assets). This knowledge is what gives subordinated debt holders, and indeed the entire market for subordinated debt, its disciplinary power.

The *Principles* Statement therefore recommends that regulators harness this unique source of stable market discipline by requiring larger banks (above some size threshold) that are capable of selling subordinated in the public capital markets always to maintain at least a minimum amount of such debt (in proportion to the organization's assets). Furthermore, this debt should convert to equity in times of stress, which would have the benefits outlined earlier. The market value of such debt (including the market interest rates the prices of the debt would imply) would provide an important additional signal of the financial health of institutions to markets, the affected banks, and regulators.

Promoting Home Ownership in the Future

Even after the financial crisis and the excesses in mortgage lending that triggered it, home ownership remains important. Among other things, home ownership is an important part of the "American Dream" and contributes to stable neighborhoods.

U.S. policy has recognized these benefits by subsidizing home ownership in various ways since the Depression. Up to now, these subsidies have been channeled heavily through the mortgage market and in ways that often are not reflected in the federal budget. Most notably, the implicit federal guarantee of the debt issued by the two main housing government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – was never recorded as a subsidy on the federal government's budget. Only after the federal government took over both institutions and placed them in conservatorship has the mounting cost of that subsidy – reflected in the costs of making good on the GSEs' guarantees of the securities it has issued, in the capital injections supplied to both institutions to keep them going, and in the costs the institutions and thus the government has borne in the modification of mortgages that the two GSEs hold in their portfolios or that back securities they guarantee – finally been reflected as a budgetary cost.

In contrast, the subsidies provided by the Federal Housing Administration (FHA)--which primarily guarantees mortgages to low and moderate income families -- have been recorded on the budget, since that body all along has been a government agency. But with rising defaults, FHA is faced with the prospect of needing additional federal funds to make good on its commitments too.²⁹

²⁹ At this writing, we and no one else knows the final bill for resolving the fate of the two housing GSEs and the FHA. Just before the end of 2009 the Administration announced that it was lifting both the previous \$400 billion cap on the government's commitment to Fannie Mae and Freddie Mac, and the cap

Preferential financing from the GSEs and non-recourse lending, however, have encouraged households to take on much more risk than they otherwise would have done. This became especially evident during the several years preceding the financial crisis, when the GSEs were buying large and increasing amounts of securities backed by Alt-A and subprime loans. The GSEs also were at risk because of thinner capital cushions than commercial banks. So when residential real estate prices peaked in 2006 and then began plunging, the GSEs began experiencing mounting losses on their mortgage portfolios, which quickly ate through their capital, eventually resulting in both institutions being placed in conservatorship.

Given this history, the signatories of the *Principles* statement urge two major reforms.

First, subsidies for home ownership in the future should be direct, transparent and on-budget, rather than channeled indirectly and opaquely through quasi-private, quasi-public entities like the former GSEs. In addition, all homebuyers should provide some equity (which could be matched by the federal government). The era of the no down-payment mortgage should be over.

Second, after the economy has significantly recovered from the recession, the two housing GSEs (Fannie Mae and Freddie Mac) should be restructured either into on-budget government agencies or into purely private entities. The financial crisis has demonstrated (among other things) that it is not viable for the federal government to impose public objectives (affordable housing) on private entities whose debt and guarantees are implicitly backed by taxpayers. If citizens want their government to aid housing through the mortgage market, then the entity that does it should be the government. Alternatively, if citizens prefer that any public support for home ownership be provided solely through direct subsidies, then purely private entities should be engaged in the business of providing guarantees for mortgage or securities backed by them.

Third, the FHA should be reformed. If only direct subsidies for home ownership were provided, there would be no need for the agency or its guarantee function. However, if the agency is retained, its underwriting criteria need to be tightened and its insurance fees increased for it to avoid the kinds of losses it has been recently experiencing. In this regard, its recent reforms move in the right direction, although it is unclear at this point whether they will prove sufficient to ward off a taxpayer bailout of the agency.³⁰

Summary

on the institutions' future borrowing. Accordingly, the government's cost will be unbounded until the fate of all these entities (including the FHA) is resolved in one manner or another.

³⁰ In late January 2010, the FHA announced that was going to phase in over a two year period an increase its upfront insurance fee from 1.75% to 2.25% of the loan amount. In addition, to boost its dwindling reserves (which at year end 2009 had fallen to \$3.6 billion, or roughly 0.5% of the \$685 billion loans it has guaranteed, down from 3% a year earlier), the agency is asking Congress to increase a separate annual insurance premium. Although FHA is so far retaining its standard down-payment requirement of just 3.5%, it announced in January that henceforth borrowers with credit scores below 580 will need to post a minimum 10% down-payment.

In sum, the *Principles* Statement recommends the following multiple steps for enhancing market discipline across a range of markets and financial institutions:

Over-the-counter (OTC) derivative transactions should be recorded with trade registries. Collateral in OTC transactions should be managed by third parties. The migration of OTC transactions onto clearing houses and exchanges should be encouraged through capital requirements assessed on OTC instruments that are not centrally cleared.

A private Securitization Board should be created to establish best practices at every stage of securitization including credit ratings. The credit ratings process can and should be reformed in several ways.

Executive compensation should be aligned with risk in financial institutions. Large banking organizations with access to the capital markets should issue subordinated debt.

Home ownership subsidies should be transparent and on-budget. The FHA and the GSEs should be reformed.

Consumer protection

Finally, the Task Force is persuaded that unethical and deceptive practices in the sale and promotion of financial products and services were a contributing factor in the run up to this crisis. Given all of the perverse public policies that encouraged or allowed the origination and securitization of mortgages that should never have been extended to too many homeowners with less-than-prime credit histories, it should not be a surprise that unscrupulous lenders took advantage of those incentives to convince some of those homeowners to assume mortgages with onerous terms that were not in their best financial interest. But in an originate-to-distribute system, the originators of these mortgages did not care if the borrowers were able to repay, as long as the mortgages could be and were easily and quickly sold to others in the mortgage securitization pipeline.

In principle, various federal and state consumer protection statutes should have protected homeowners against abusive mortgage practices. But state regulation of non-depository mortgage lenders was weak and under-staffed, while the federal banking agencies gave consumer protection short shrift because all along they have viewed their top priority to be to protect the safety and soundness of the banks under their watch (a job, it turned out, they did not perform well either).

The Task Force considered various ways to reform consumer financial protection, including the beefing up of enforcement personnel at the existing banking agencies, transferring all consumer financial protection regulation to the Federal Trade Commission (FTC), or creating a new federal agency to do this job. In the end, the *Principles* statement reflects the view that, even with additional resources, the banking agencies will always consider consumer protection a second priority to micro-prudential regulation. As for the FTC, it already has very broad missions –

consumer protection for the entire economy as well as antitrust enforcement authority – that would complicate its ability to give financial products consumer protection in particular the attention that it deserves.

Accordingly, the *Principles* statement agrees with the proposal to create a new Consumer Financial Protection Agency that combines within it all of the consumer protection powers of the existing federal financial regulatory agencies. To pursue this single broad mandate, the CFPA should have all necessary rulemaking, enforcement and preemption powers needed to develop the necessary understanding and expertise, to support the development of a flexible national market for financial products and services and to protect consumers everywhere.

The CFPA's jurisdiction should extend to all consumer financial products and services and related providers with certain exclusions for products and services currently regulated by the SEC and the CFTC, and for small service providers including those whose financial activities are only incidental to another business. Furthermore, because financial services are developed for and marketed to a nationwide customer base, the CFPA should set national rules and enforce them. State regulation of financial products should, therefore, be preempted.³¹

The Chairman and the Board of the CFPA should be appointed by the President and confirmed by the Senate. The Chairman of the NFR should be a Board member, ex officio. To ensure that any unnecessary regulatory burdens and conflicts are avoided, the CFPA Board should include strong representation from the other federal financial regulatory agencies.

In sum, the *Principles* statement endorses the following proposal to enhance the protection of consumers of financial products and services:

A new federal Consumer Financial Protection Agency (CFPA) should be created with the sole mandate of protecting consumers of financial products and services. The CFPA should have powers of rulemaking, enforcement and preemption of state rules. All the powers for consumer protection for financial products and services currently assigned to federal financial regulatory agencies should transfer to the CFPA. The other federal financial regulatory agencies should be represented on the CFPA Board to ensure balanced deliberation and coordination of policy.

Conclusion

The financial crisis of 2007-08 has revealed many weaknesses in policies relating to the housing market and to the regulation of financial institutions more broadly. Improvements are required in both regulation and in ways to harness market discipline more effectively, so that future crises are less frequent and less severe.

It has now been more than 18 months since the crisis reached its peak in September 2008. Although some of the nation's largest financial institutions that were on the brink of failure then have now come back – with capital infusions and other means of federal support – this is no time for policy makers to be complacent. The Task Force believes that major financial reforms are urgently needed. We hope that our preceding *Principles* statement and now this

³¹ The Task Force considered, but did not endorse, the concept of giving the states concurrent enforcement authority only of the national rules set by the CFPA.

document will be helpful to policy makers as they complete the legislative process of bringing these reforms to fruition.