Lessons and Consequences of the Great Recession for Financial Regulation

Patrick Bolton
Columbia University

How to deal with *too-big-to-fail* banks in the aftermath of the crisis?

- Resolution Mechanism for BHCs
- Living Wills
- “Too big to fail” or “too big to manage”?

Bail-out or Bail-in?

- Bailout fund financed by a transaction tax
- Repo Utility
- Moral Hazard
- Political & Regulatory forbearance
Outline 2

4. How to regulate Shadow Banking?
   – Incentives of originators and servicers?
   – Off or on the balance sheet?
   – Rating ABS
   – The role of CDS
   – Capital requirements

5. Regulating Systemic Risk and Capital Requirements
   – Systemic risk regulator?
   – Amending Basel II: counter-cyclical capital requirements? CoVar?
   – Stress tests
Causes of the Crisis

• Real estate bubble, excess borrowing,
• Fragility of **shadow banking** and originate & distribute model:
  – Poor incentives at origination,
  – No protection against *panic run* in *repo market*
    (see Gorton, 2008 and Adrian and Shin, 2009)
  – Conflicts of interest at *credit ratings agencies*
  – short-termist *quick kill* incentives in banks
  – excess leverage
• Regulatory and Political failure
Regulatory and Political failures

• **SEC** didn’t supervise Investment Banks adequately under Basel II rules introduced in 2005,

• **OTS** failure to supervise AIG, Countrywide, IndyMac, and Washington Mutual.

• Fed *forbearance* in the face of housing and asset price bubble & lending boom

• Non-interventionist stand of the Bush administration

• **Regulatory Maze**…
Too Big to Fail

1. Consolidated Supervision of Tier 1 FHCs (by whom? FRB? FDIC?)
2. Financial Services Oversight Council & European Systemic Risk Council
3. Resolution Mechanism for BHCs
4. Living Wills
5. “Too big to fail” or “too big to manage”? 

• What is a Tier 1 FHCs? An FI with systemic importance under stressed economic conditions

• Impact of HC’s failure on other banks, payment, clearing & settlement systems

=>

• Tighter standards & closer supervision for Tier 1 FHCs

• **Main Concern**: implicit guarantee
Systemic Risk Councils

- **What will they do?**
  - identify emerging systemic risks,
  - improve interagency cooperation

- **How will they operate?**
  - Board of regulators
  - Permanent expert staff
  - Hold meetings?
  - Run a systemic risk seminar series?
Resolution Mechanism for BHCs

- bankruptcy (chapter 11) & prompt closure rules → default mechanism,
- **Systemic risk exception:**
  - authority to establish *conservatorship* or *receivership* for failed BHC
  - authority to provide new loans & guarantees, purchase or sell assets, make equity investments
Living Wills

• Tier 1 FHC would be required to set up their own rapid resolution mechanism,
• Lower regulatory capital if FHC has:
  – Contingent capital commitments
  – Restrictions on dividend payments
Too big to manage?

• Break up Tier 1 FHCs?
• Create smaller, less interconnected HCs?
• How to break up?
  – IB vs. CB à la Glass-Steagall?
  – Return to partnership model for IBs?
Bail-out or Bail-in?

• “...always come to the rescue...but always leave it uncertain whether rescue will arrive in time or at all...”


• “We want to keep the markets calm and the Russians scared”

Bail-out or Bail-in?

- **Deposit insurance** is a form of automatic Bailout
- Extend insurance to repos?
- **Repo utility** proposal (*NewBank*): A central clearing utility for collateralized short-term debt
  - would replace *Bank of New York Mellon* and *J.P. Morgan Chase* (*J.P. Morgan was Lehman's repo clearing bank*)
- **Main Advantage**: safeguards the *plumbing*; keeps the financial system running in a crisis
Bail-out or Bail-in?

- Broader **Bailout** of Tier 1 FHCs?
  - *New British Proposal*: bank bailout fund financed by a financial transactions (Tobin) tax

- **Main Concerns:**
  - Moral Hazard
  - Political & Regulatory forbearance
Regulating Shadow Banking

1. Growth of securitization and repo markets

2. Growth in subprime mortgages
Securitization before the crash

Figure 4. New Issuance of Asset Backed Securities in Previous Three Months (Source: JP Morgan Chase)
Why Securitize?

4 main reasons:

1. **Risk Diversification**
   - diversified asset pools

2. **Distribution to long-term investors**

3. **Asset-liability matching**;
   - Match asset income with debt expense.
   - Reduces interest rate risk.

4. **Conserve on Capital**;
   - Transform illiquid assets into cash.
   - Use cash to make more loans.
Shadow Maturity Transformation

Source: Federal Reserve Board

MBS Credit Ratings Failure

Credit Ratings Agencies:
1. Failed to foresee downturn in real-estate prices
2. Did not foresee refinancing risk for subprime loans
3. Relied on imperfect historical data of past prime lending
4. Ignored moral hazard in origination,
5. Invited manipulation through tranching, credit enhancement, etc.

How to regulate Shadow Banking?

1. On or off the balance sheet?
2. Incentives of originators and servicers?
3. Rating ABS
4. The role of CDS and repos?
5. Capital requirements
On or off the balance sheet?

The **covered bonds** alternative:

- Fixed-income obligations backed by pool of mortgages and other assets
- Underlying mortgages are kept on BS
- Investor in a covered bond has recourse to the issuer
- Delinquent loans in the pool are substituted by new performing loans
- *Overcollateralization* can also be adjusted
- Inability to upgrade asset pool at request of bond trustee is a default event
On or off the balance sheet?

• covered bonds are best way of aligning incentives for origination and servicing of the loan
• covered bonds require higher equity capital commitments, but one role of equity capital is to align incentives at origination
• covered bonds make it easier for regulators to see extent of leverage (no implicit obligations; all obligations are explicit)
• tranching and allocation of risks still feasible with covered bonds
Regulating Ratings Agencies

• Financial services committee bill of US house of representatives (HR 3890) proposes to give SEC oversight over CRAs

• Key issues:
  – disclosure,
  – liability,
  – pay model,
  – competition,
  – NRSRO accreditation
Shadow Maturity Transformation, CDS & repos

- Securitization can reduce the risk associated with maturity mismatch for originator
- There is no value in transferring maturity transformation off balance sheet
- Why did shadow maturity transformation arise, when there is no deposit insurance in shadow banking?
- Treatment of repos and CDS in bankruptcy provides a subsidy to short-term financing and maturity transformation
CDS & Repos

• ISDA netting agreement for OTC derivatives markets =>
• No *stay* on CDS execution in the event of bankruptcy
• Same for collateral collection with repos
• These financial claims have the highest priority – higher than secured debt
• Implicit subsidy for these modes of financing
• Need to reconsider the *wisdom* of excluding derivatives from stay in bankruptcy that applies to most other claims
Regulating Systemic Risk

• Systemic risk regulator:
  – A separate agency?
  – Central Bank or Financial Regulator?

• Amending Basel II:
  – counter-cyclical capital requirements
  – $CoVar$: measure of how individual FI risk increases tail risk in other FIs
    (Geneva Report 11, Brunnermeier et al. 2008)

• Stress Tests!