Lessons and Consequences of the Great Recession for Financial Regulation

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Outline

1. **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"?
2. **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

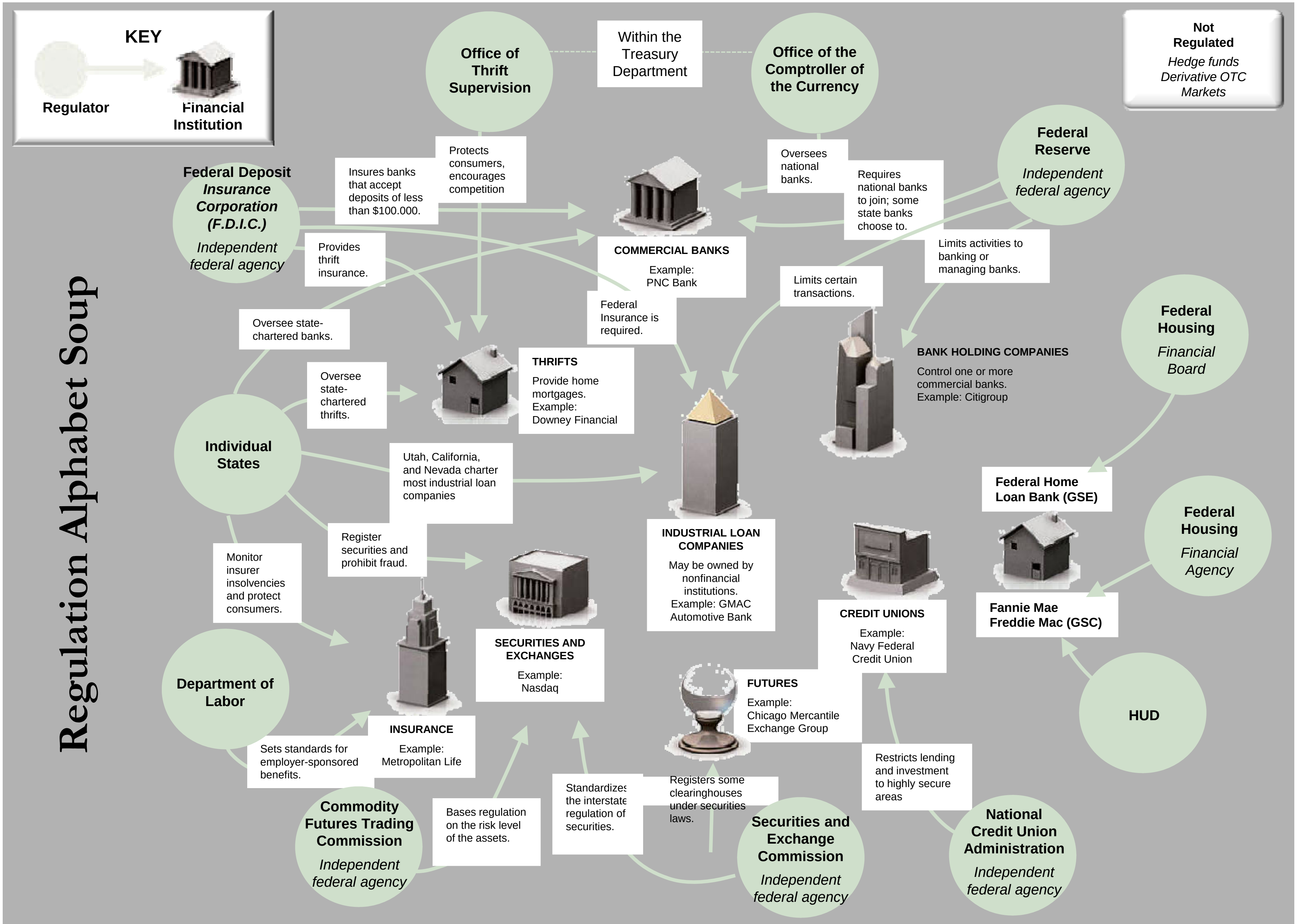
Causes of the Crisis

- **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**…

Regulation Alphabet Soup



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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"?

Tier 1 FHCs

- 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 *IB*s?

Bail-out or Bail-in?

- "***…always come to the rescue...but always leave it uncertain whether rescue will arrive in time or at all...***"

  Charles Kindleberger and Robert Aliber (2005), "Manias, Panics, and Crashes: A History of Financial Crises"

- "***We want to keep the markets calm and the Russians scared***"

  Larry Summers, quoted in Paul Blustein, (2001), "The Chastening: Inside The Crisis That Rocked The Global Financial System And Humbled The IMF"

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?

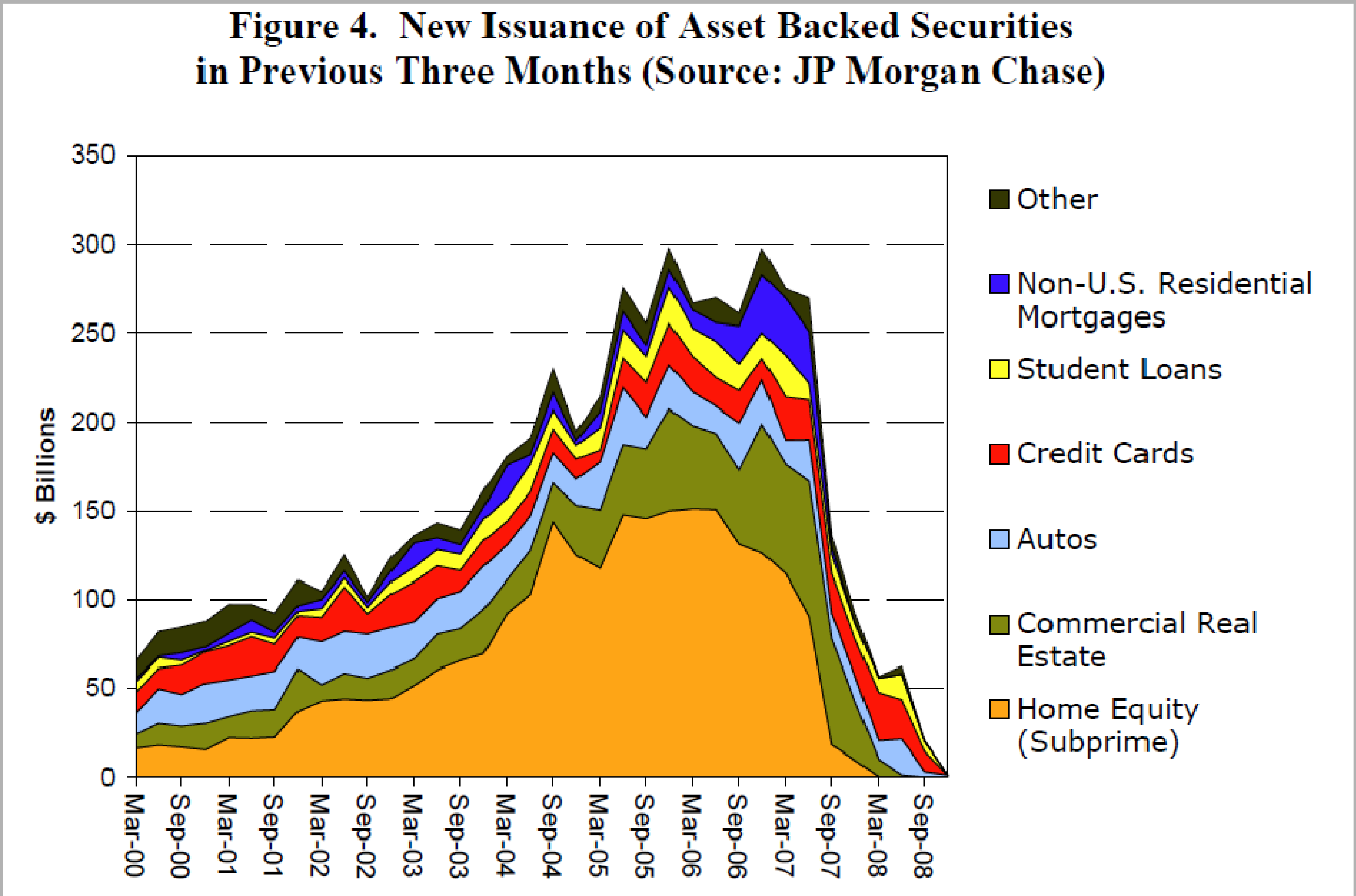
- Broader **Bailout** of Tier 1 FHCs?
  - *New British Proposal*: **bank bailout fund** financed by a financial transactions (Tobin) tax
- **Main Concerns:**
  - Moral Hazard
  - Political & Regulatory forbearance

Regulating Shadow Banking

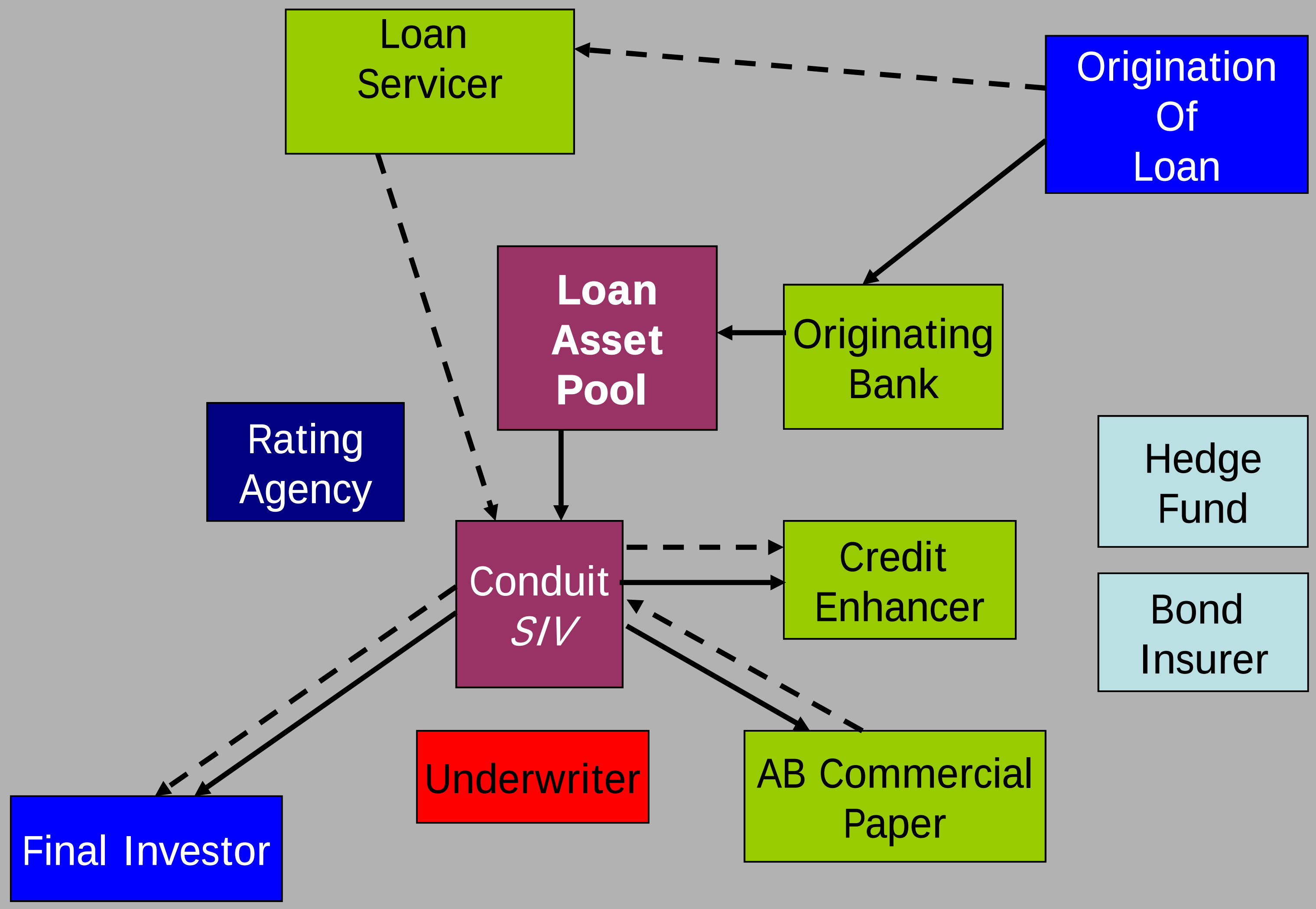
1. Growth of securitization and repo markets

2. Growth in subprime mortgages

Securitization before the crash



Securitization and the *loan-chain*

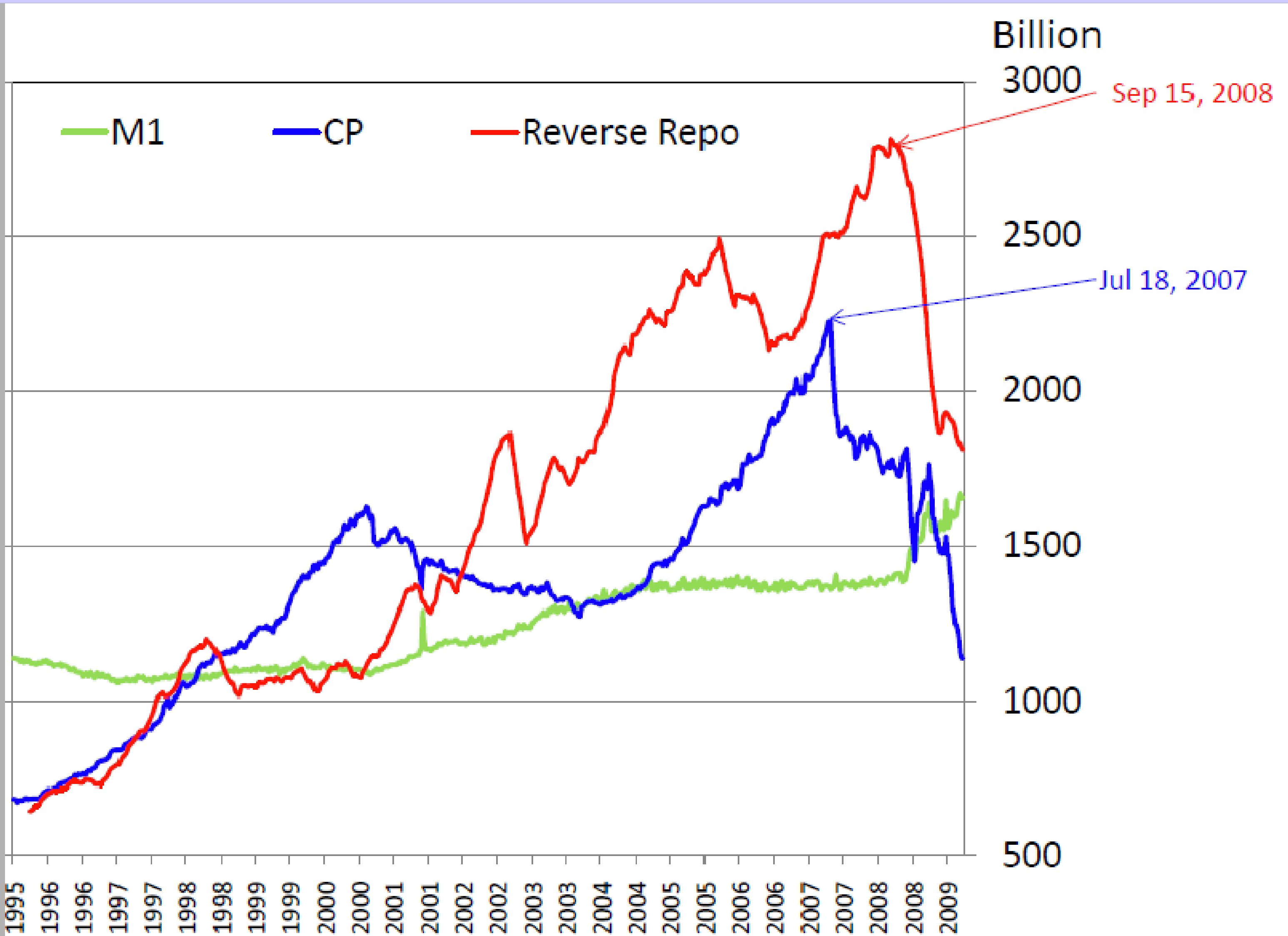


Why Securitize?

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!**