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## Reforming Financial Regulation—A conference summary

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The Chicago Fed's 45th annual Conference on Bank Structure and Competition, which took place May 6–8, 2009, brought together industry personnel, regulators, and academics to discuss the recent financial crisis and financial regulatory reform, among other issues.

The optimal regulatory solution is one that stabilizes the financial system without hindering its ability to operate efficiently.

**This** article summarizes two key panels from last year's Conference on Bank Structure and Competition—Reforming Financial Regulation and Responding to the Financial Crisis: Lessons Learned.[1]

### Reforming Financial Regulation

The theme panel for the conference was moderated by Daniel G. Sullivan, Federal Reserve Bank of Chicago. It featured Raghuram G. Rajan, University of Chicago; Diane Casey-Landry, American Bankers Association (ABA); Robert Kuttner, *American Prospect*; Hal S. Scott, Harvard Law School; and Thomas H. Stanton, Johns Hopkins University. There is almost universal agreement that the regulatory system did not function optimally during the crisis, Sullivan noted. Yet, no such consensus exists on what aspects of the system were flawed or on what needs to change.

Rajan concentrated on the means to alleviate the problems associated with financial institutions deemed *too-systemic-to-fail* (TSTF). He purposely avoided using the more common term *too-big-to-fail* because size alone does not dictate whether a firm is systemically important; the structure of the firm must also be considered. Rajan evaluated three methods to address the TSTF problem: prevent institutions from becoming systemically important; create additional private sector buffers to reduce the likelihood of failure; and make it easier for regulatory authorities to "fail" (resolve) these institutions. Regulators could take a rather blunt approach, i.e., limit institutions from expanding beyond a certain size and/or limit their financial activities. One concern about this approach, said Rajan, is that regulators would have to be given substantial discretion in determining the appropriate structure of firms. For instance, the size threshold could vary significantly for different types of institutions. Efficiency could be another concern. Rajan noted that "some institutions get large not through unwise acquisitions, but through organic growth based on superior efficiency." Setting limits on product mixes could also be difficult. For example, it would be difficult to distinguish speculative proprietary trading from hedging activities. Rajan argued that if regulators were allowed such discretion, financial institutions would attempt to evade the regulations, leading to less transparency.

Rajan also pointed out problems with subjecting systemically important institutions to higher regulatory capital requirements to cushion them against losses. If, as in the past, the market requires financial intermediaries to hold less capital than regulatory requirements dictate, there is an incentive to shift activities to unregulated and potentially riskier operations, such as structured investment vehicles (SIVs) and conduits. Also, the higher capital requirements could increase the cost of intermediation to the real economy, resulting in a drag on economic activity.

As an alternative, Rajan argued that policymakers should seriously consider implementing *contingent capital* arrangements, such as contingent convertible debt[2] or fail-safe insurance.[3] With convertible debt, financial institutions would issue *reverse convertible bonds* to private investors. These debt instruments would convert to equity when two conditions are satisfied: the system goes into a crisis as declared by a supervisory institution and the bank's capital ratio falls below some predetermined level. When the bonds convert, the capital position of the bank could be bolstered and the need for bankruptcy or a costly bailout could be avoided. These instruments would also provide an incentive for firms to raise new equity in order to avoid the dilution of existing shares from the forced conversion.

See www.chicagofed.org/BankStructureConference for information on the 2010 Bank Structure Conference.

Under a fail-safe insurance plan, Rajan said, systemically important financial institutions would buy fully collateralized insurance policies from unlevered investors. Insurance providers could include sovereign wealth funds or private equity funds. A principal amount from the investor would be invested in safe assets (e.g., U.S. Treasury bonds) and placed into a custodial account. Every quarter the systemically important institution would pay a predetermined insurance premium that, together with the interest accumulated on the Treasury bonds, would be paid out to the investors. If aggregate bank losses exceed a pre-specified amount, the institution would receive a payout from the investor's principal to bolster its capital position. Systemically important institutions would be barred from acting as investors in such policies in order to limit interconnectedness problems.

Bailouts might be avoided if regulators could resolve insolvent banks more easily, said Rajan. Regulators should collect detailed information on institutions' balance sheets to determine potential spillover effects in the event of a failure; and banks should be required to develop and maintain shelf-bankruptcy plans, which would outline how their operations could be resolved in an orderly and timely manner. Developing such plans would force firms and regulators to identify potential problem areas and create incentives for banks to make their structures less complicated and easier to resolve. Rajan also recommended the creation of a new resolution authority over bank holding companies (BHCs) and nonbank financial entities.

Casey-Landry argued that the global financial turmoil was caused primarily by the less regulated shadow banking industry—a network of lenders, brokers, and opaque financing vehicles outside the traditional banking system—and that new regulations should focus on that sector. While prudential regulation should apply to all financial institutions, she argued that policymakers should avoid adding additional regulatory layers to the already regulated banking sector. Casey-Landry also noted that labeling an institution as systemically important could cause market disruptions and adverse problems for community banks. Regulators should be empowered with new resolution authority for BHCs and nonbank financial institutions, she said, although the ABA strongly opposes giving resolution authority for nonbanks to the Federal Deposit Insurance Corporation (FDIC), whose expertise is in resolving banks and thrifts.

Kuttner argued that the recent financial turmoil was not simply an unwarranted panic, but a crisis of asset misevaluation. He contended that losses on bad assets should be realized as soon as possible to prevent a period of industry stagnation. In addition, he claimed that "most of the tools existed to prevent this [crisis], but they were neutered by ideological fashion and by political corruption that was bipartisan." Kuttner also expressed concern that the short-term Federal Reserve and Treasury solutions to the crisis had actually exacerbated the TSTF dilemma, as evidenced by the consolidation of some large financial institutions. He argued that all large financial institutions had been implicitly designated as TSTF and that any new regulatory framework should first address this situation because it creates a significant moral hazard problem—i.e., large institutions will continue to take on excessive risk, confident that if their investments go awry they will be bailed out.

Scott addressed three broad policy areas for dealing with systemic risk: bank transparency, the use of clearinghouses and exchanges, and the efficient resolution of insolvent institutions. Market discipline, Scott argued, should force financial institutions to hold sufficient amounts of capital, in both good and bad times. Yet he emphasized that this can only be achieved if investors and counterparties are fully exposed to risk and if there is broader disclosure of the activities and risk levels of financial institutions. To encourage additional disclosure, Scott proposed that regulators release risk ratings (e.g., CAMELS) and substantial portions of examination reports. He said that if properly implemented, "calm, not volatility or panic, will be the result of broader disclosure."

In addition, Scott recognized the need for clearinghouses and derivative exchanges to play an important role in reducing systemic risk. Without such a role, the failure of one financial institution could cause counterparty losses on derivatives contracts, producing a chain reaction of additional failures. A clearinghouse can reduce this risk by becoming the central counterparty to each derivatives contract. As a result, the failure of one institution is "covered" by all the members of the clearinghouse, thereby reducing spillover risk to individual counterparties. However, Scott said that such concentration of risk requires that the clearinghouse put adequate risk-management procedures in place—such as capital adequacy requirements, margin requirements, and a backup clearing fund.

Finally, Scott agreed with other panel members that a new resolution authority for BHCs and nonbank financial institutions could help reduce systemic risk. Without adequate resolution authority, either insolvent banks must enter traditional bankruptcy—which can have severe repercussions for the financial system, as exemplified by the failure of Lehman Brothers—or the government must prop them up with taxpayer money. He therefore concluded that it would be better to restructure insolvent TSTF banks through receivership.

Stanton spoke about financial regulatory reform from the "public administration" perspective, which addresses how authorities implement new policy. He first discussed the failure of Fannie Mae and Freddie Mac—two government-sponsored enterprises (GSEs). He argued that the failures stemmed directly from organizational vulnerabilities of the GSE model. The model is inherently conflicted because GSEs must balance fiduciary responsibility to shareholders and the public interest. He suggested that for the foreseeable future, the government keep Fannie and Freddie in receivership as wholly owned government corporations to support the mortgage market.

Because "risk will migrate to the place where government is least equipped to deal with it," Stanton suggested creating a staff within the federal government's Office of Management and Budget to evaluate and enhance the capabilities of federal agencies in providing efficient responses to crises. He also recommended creating an agency that would be authorized to gather information from financial regulators but would not have supervisory authority. It would monitor risk and give reliable, unbiased recommendations to regulatory authorities. Lacking supervisory authority, this agency would have fewer problems associated with regulatory capture (i.e., when regulators become dominated by the industries regulated).

### Responding to the Financial Crisis: Lessons Learned

The other key panel was moderated by Douglas D. Evanoff, Federal Reserve Bank of Chicago. It featured Anil K Kashyap, University of Chicago; Kiyohiko G. Nishimura, Bank of Japan; Andy Haldane, Bank of England; and Vincent R. Reinhart, American Enterprise Institute.

Kashyap discussed lessons learned from the recent deleveraging process. He argued that deleveraging created contradictions in the credit markets that were aggravated by capital requirements. As asset values fell and capital levels shrank, banks were forced to raise new capital or sell off risky assets in order to satisfy regulatory requirements. Capital was scarce, and as a result, banks were forced to sell assets. This generated further price depreciation, which affected the capital level of the whole system, not just that of an individual bank. This cycle drove asset prices down to the point where numerous institutions faced insolvency.

Consequently, Kashyap suggested that the Basel II Accord's method of regulating on a firm-by-firm basis is deficient because it does not capture the adverse effects for the entire system. He recommended that the regulatory arm should extend beyond banks to any institution that could produce large-scale asset sales. Additionally, troubled institutions should be forced to recapitalize instead of shrink, preventing asset fire sales and the associated adverse spillover effects. He advocated the use of contingent capital arrangements as a means to implement the recapitalization requirement.

Kashyap also discussed the need to improve the failure resolution process. He contended banks would continue to use short-term financing, subjecting them to deposit runs and making normal bankruptcy procedures unworkable. Thus, a new resolution authority is needed, he argued, and shelf-bankruptcy plans could enhance that entity's effectiveness.

Nishimura compared Japan's *lost decade* (1991–2000) with the current situation in the U.S., explaining that the sources of both crises were in the property markets. In Japan, it was commercial properties in central business districts; and in the U.S., it was subprime residential mortgages. Banks in both countries faced heavy losses, resulting in an adverse feedback loop—i.e., the slowing financial markets induced greater caution by lenders, households, and firms, weakening the real economy, which fed back to even more weakness in financial activity and even more caution, and so on. Nishimura noted that U.S. and Japanese policy responses had also been quite similar—including a large fiscal stimulus and an aggressively expansive monetary policy. Despite such aggressive policies, said Nishimura, an adverse feedback loop is difficult to stop because the valuation process for troubled assets becomes highly uncertain. Buyers and sellers have difficulty producing reasonable loss estimates, and as a result, the market shifts to a "wait and see" strategy. This erosion of confidence produces an aversion to uncertainty, which then affects investment and economic activity.

Nishimura stressed the need to proceed carefully in designing new regulations. He pointed out that the origins of financial crises often lie in areas where regulators have little information or authority. Subsequently, the financial system and regulators must prepare for the worst-case scenario during good times.

According to Haldane, regulators should have seen that something was amiss in financial markets as the crisis approached. During the 20 years leading up to the current crisis, the financial industry had experienced large excess returns compared with the broader market—a historical aberration. He argued that most of these excess returns were a result of the financial industry's use of leverage, instead of a superior return on assets.

Haldane could see a potential need for differential regulations based on institution



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size because it had been the large firms that had pushed a bad situation into a major crisis. He argued large firms were able to hold less capital, most likely because the market assumed they would be bailed out in a crisis. This assumption was probably appropriate, since his data showed a positive linear relationship between firm size and the size of the federal government's capital injections.

Finally, Haldane noted that, while the payments and settlement systems functioned well during the crisis, some over-the-counter (OTC) markets did not. These markets became too complex and interconnected to effectively price counterparty risk. To avoid similar problems in the future, he advocated the use of clearinghouses in OTC markets, such as the credit default swap market.

Reinhart concentrated on problems associated with government intervention. Interventions can distort private incentives so that management and counterparties are less disciplined, increasing risk to the financial system. In addition, inconsistent government intervention policies can create uncertainty. As a result, private capital could exit the system, and the government would be left to fill the void.

Government intervention created the TSTF problem, Reinhart contended. The more complex and interconnected an institution is, the greater the effect its failure would have on the system. The probability that the government will bail out an institution increases with its level of complexity. Accordingly, counterparties will price in the probability of government intervention, providing complex firms with a funding advantage. He noted that this government-induced distortion gives firms incentives to become more complex. Ironically, the greater complexity makes the firm more difficult to manage, increasing risk to the firm. Overall, this makes the financial system more vulnerable to crises and increases the need for government intervention.

Reinhart argued that another layer of supervision is not necessary, nor is there a need for a special resolution authority. Instead, he proposed a "modular solution," where a financial holding company is composed of parts that can be disconnected and reassembled. In the event of a crisis, systemically important parts can be protected in bankruptcy. The modules that are not systemically important can be left to the market. This proposal involves reducing the number of corporate charters and agencies, consolidating balance sheets, and giving up efficiencies related to scale and scope. Reinhart argued that these changes would facilitate international cooperation, make prepackaged bankruptcy a viable option, and improve economic efficiency.

## Conclusion

The 2009 conference facilitated important discussions about financial regulatory reform and lessons learned from the recent crisis. Reflecting on the crisis, Federal Reserve Chairman Ben S. Bernanke stated in his keynote address: "It is imperative that we apply the lessons of this experience to strengthen our regulatory system, both at the level of its overall architecture and in its daily execution." In considering regulatory reform, we must understand how the crisis developed, what aggravated the situation, and how well the political and regulatory systems functioned. Also, we must consider the ramifications that reform will have on the financial system and on the real economy. The optimal solution is one that stabilizes the financial system without hindering its ability to operate efficiently. Efforts are under way to create that optimal framework. Progress toward that goal will be discussed at the 46th annual Conference on Bank Structure and Competition, to be held May 5–7, 2010.

[1] For more information on the 45th annual Conference on Bank Structure and Competition, see www.chicagofed.org/webpages/events/2009/bank_structure_conference.cfm.

[2] See Mark Flannery, 2005, "No pain, no gain? Effecting market discipline via 'reverse convertible debentures,'" in *Capital Adequacy Beyond Basel: Banking, Securities, and Insurance*, Hal S. Scott (ed.), Oxford, UK: Oxford University Press, chapter 5; see also the Squam Lake Working Group on Financial Regulation, www.squamlakeworkinggroup.org.

[3] Anil K Kashyap, Raghuram G. Rajan, and Jeremy C. Stein, 2008, "Rethinking capital regulation," paper at Federal Reserve Bank of Kansas City Economic Symposium, Maintaining Stability in a Changing Financial System, Jackson Hole, WY, August 21–23, available at www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.08.08.08.pdf.