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Statement of the Shadow Financial Regulatory Committee on

An Open Letter to President-Elect Obama

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In addressing the current financial crisis your new administration will face three critical tasks. The first is managing the ongoing mess. The second is to effect an orderly unwinding of the emergency measures the previous administration put in place to bolster financial institutions and markets. The third is to develop a comprehensive policy strategy that will help to shape the financial system of the future.

Effective crisis management solutions must address fundamental causes rather than symptoms. Among the many causes of the crisis are government credit-allocation schemes that distort incentives and adversely affect the function of markets while undermining the effectiveness of private and government supervision. As in this case, such incentive distortions eventually produce financial crisis.

Unfortunately, most of the current administration's remedies ignore the incentive distortions and treated financial institutions' problems in rolling over their debts as arising from a shortage of market liquidity rather than doubts about the solvency of troubled institutions. Ad hoc and short-sighted interventions inevitably have adverse longer-term consequences. For example, much of the financial architecture put in place in the 1930s was crafted in the heat of crisis resolution. Despite the effectiveness of some of the emergency interventions of the 1930s, other policy responses were unwarranted and ended up hobbling financial institutions for decades, with significant unintended adverse consequences for financial system efficiency and bank risk management.

Many factors contributed to the current crisis, including a prolonged period of low interest rates from 2002 to 2005. Most importantly, government policies (especially policies toward Freddie Mac and Fannie Mae) to encourage housing have distorted risk management, prudential supervision, and pricing in the mortgage market. Inadequacies in banking supervision and regulatory policies, and the outsourcing of due diligence by both regulators and private sector market participants to rating agencies when coupled with private-sector agency and incentive problems have encouraged excessive leverage and poor underwriting standards.

The Shadow Financial Regulatory Committee would like to highlight what it sees as important lessons from the current crisis in five key areas requiring ongoing policy attention, and articulate principles that should guide long-term reforms and the unwinding of the emergency measures put in place to bolster financial institutions and markets. The five areas are: 1) government policies to subsidize affordable housing, 2) rules defining the limits of safety net protection for the financial system, 3) policies governing financial institution consolidation and competition, 4) prudential regulation and supervision of financial institutions, and 5) disclosure standards and other rules ensuring transparency in financial transactions and positions.

U.S. housing policies have used off-budget expenditures and mandates to increase the availability of housing. This approach operates by distorting the incentives of market participants in order to achieve government objectives. Government policies affect the housing market by lowering interest rates, encouraging high loan-to-value ratios and high lender leverage, and expanding the supply of mortgage credit. Policies have done so in a variety of ways including: the creation of specialized and implicitly subsidized mortgage institutions (i.e., Freddie Mac, Fannie Mae, the Federal Home Loan Banks, FHA, and Ginnie Mae) and the rules that govern their lending policies, favorable tax treatment of mortgage interest, lower risk-based capital standards for financial institutions on mortgage loans, and bank regulations that encourage mortgage lending such as the Community Reinvestment Act, which together constitute the most important policy initiatives.

Particularly problematic has been the behavior of Freddie and Fannie, which exploited their once implicit government guarantees to dominate the mortgage business. As the result of their expansion into risky mortgage lending from 2004 to 2007, they amassed huge risk, leading to losses that led them to be placed into conservatorship. The U.S. government is now managing approximately $5 trillion of mortgage-related assets. Of that amount, estimates are that Freddie and Fannie now hold more than $1.5 trillion in subprime and Alt-A mortgage-related assets, constituting roughly half of the total amount of subprime and Alt-A mortgage debt outstanding. The risks associated with these mortgages are now even more likely to be visited on the U.S. taxpayer. The Federal Home

Loan Banks were also indirect conduits of funds into the mortgage market, for example, by supplying more than half of the funds to the now failed thrifts, Countrywide and IndyMac.

Your administration must not only figure out what the future of these institutions and their assets will be, but also what the structure of mortgage finance in the U.S. should be going forward. The Committee believes that it is imperative that the assets and activities of the GSEs be completely returned to the private sector as soon as feasible. Possible alternative resolution methods include sale, liquidation, breakup or re-capitalization.

Whatever alternative is chosen, deliberations should be preceded by a reevaluation of how government housing support is structured. Experience has shown that past policies have failed and that running subsidies off-budget through mortgage markets creates financial instability. Government support for the GSEs was a quid pro quo for their relaxation of underwriting standards in mortgages targeted toward low-income borrowers. This approach encouraged substantial increases in loan-to-value ratios and relaxed risk standards. We urge that strong consideration be given to use of alternative means of promoting access to housing, including direct subsidies, which can be explicitly targeted to desired recipients (such as new homeowners) at known costs that are on budget.

In a head-spinning sequence of evolving policy interventions over the past year the Fed and Treasury have implemented scores of new ad hoc policies that broaden and deepen government protection of financial institutions, depositors, and various financial instruments. Fed lending (sometimes with Treasury support) has been expanded to accept new types of collateral, including very risky financial instruments. Fed loans have been made for new purposes (e.g., loans to investment banks, loans supporting assisted acquisitions of investment banks, and loans to foreign markets in need of dollars). The Fed and Treasury have intervened to buy money market instruments directly to stabilize those markets. Deposit insurance has been expanded to cover larger deposit balances and non-depository liabilities of banks and government guarantees have been made available to money market mutual funds. The Fed, Treasury and FDIC have pursued a variety of creative resolution policies that have selectively offered different forms of bailouts to numerous financial institutions (e.g., government injections of funding of various kinds, guarantees of assets, and subsidies to assist acquirors of distressed institutions).

All of this has been done in the absence of a policy strategy that would define the limits of safety net protection to institutions, financial instruments, and depositors under varying economic circumstances, or any statement of mechanisms and rules that would govern the provision of protection under those varying circumstances. These ad hoc policies pose four problems for the new administration.

First, because policy has been hard to predict, even potentially helpful interventions have sometimes produced shell-shocked uncertainty in markets about how future policy is likely to evolve. With an aim to reduce uncertainty caused by unpredictable policy, your administration should clearly define its overall crisis management strategy, so that the stabilizing effects of policy interventions can be realized.

Second, as the crisis passes, the government must devise a process for the orderly unwinding of government protection. For example, at some point the Fed will have to stop buying commercial paper, stop lending against risky assets, and start the process of shrinking its balance sheet, which currently contains a large amount of hard-to-sell risky assets. Managing this withdrawal of protection in an orderly manner will be a challenge. Your administration must roll back the expanded protection of bank liabilities. This will be a daunting political task because large banks and community banks both have a strong stake in continuing these protections.

Third, the adverse long-term consequences of increased protection must be addressed. The precedents established by the dramatic expansion of government involvement and protection in markets and institutions could create enormous moral-hazard costs, if market participants anticipating future government support choose to increase their risk taking at taxpayers' expense. In particular, there is a danger that market participants will load more positions onto risks that tend to affect many market participants together, and thus tend to invite more government protection. The threat to government deficits and to long-term efficiency in the allocation of financial resources from moral hazard is real and potentially large. Your administration must develop a strategy that properly protects taxpayers and ensures efficiency of the financial system by promoting competition and limiting the extent of anticipated future bailouts.

Fourth, to deal efficiently with future turmoil, it is imperative that your administration develop a new long-term policy strategy that identifies and announces operational processes and standards and loss-sharing rules associated with systemic intervention. This would include criteria for selecting candidates for assistance in crisis circumstances. This strategy must articulate credible and clear intervention mechanisms for the future that provide assistance in ways that minimize moral-hazard costs. The FDICIA of 1991 represents a model on which to build going forward. In that Act, extraordinary support for uninsured bank deposits or other debt can only occur under well-defined processes, and entail specific ex post loss sharing rules. These procedures make authorities more accountable by creating a need to justify publicly any and all ad hoc deviations from benchmark policies.

Several large financial institutions have either failed, were merged out of existence, or were sold to acquirers through assisted transactions. All required explicit or tacit regulatory approval under current antitrust laws. In each case, approvals were justified and normal antitrust standards or deposit concentration limits that might have precluded many of the transactions did not apply. The result has been the consolidation of many large banks and the virtual disappearance of the nation's large, standalone investment banks which either failed, were merged into commercial banks, or adopted the bank holding company form of organization.

The U.S. banking system is now more topheavy than ever. If there was any doubt that the top tier institutions were too-big-to-fail, that doubt has now become a certainty as these institutions are clearly viewed as too large to permit to fail or be liquidated. The industry structure is barbell-shaped, comprised of a handful of huge institutions and many small community and regional banks who must operate without the government's implicit guarantee. The implementation of the TARP program has reinforced the trend toward consolidation and also raised a number of concerns relating to the uneven distribution of government protection. Reportedly, government discretion has been used to pick winners and losers in the acquisition arena. The result is that some smaller banks face an uncertain future as the result of policy uncertainty, which raises issues both of fairness and efficiency.

An important longer-run issue is how consolidation will evolve, and how it will shape the future structure and performance of banks. Moral hazard resulting from too-big-to-fail is a significant and even larger issue. Recent experience has suggested that large institutions were difficult to manage and, in particular, experienced difficulty in controlling their risk taking. If that is so, then they have become even larger and more complex as the result of the consolidations that have taken place. Government policies should not tilt the financial system toward further consolidation. Instead, policies should recognize the disproportionate systemic risks posed by large, complex institutions. As the risks to the safety net are unlikely to be linear in measures of bank size and complexity, the Committee recommends the imposition of an ex ante systemic risk premium surcharge to internalize the social costs of managing systemic risks in the financial system.

The depth of the current financial crisis has been blamed widely on the failure of market forces to impose sufficient discipline on risk-taking by a series of interconnected large financial institutions. Adherents to this view conclude that the way to reduce the frequency and extent of future market turmoil is to require the government to undertake more stringent regulation of risk-taking by banking, securities, and insurance firms.

However, a careful reading of the evidence produces a more nuanced view. While the crisis shows the limits of market discipline, the failure to control private risk taking is the product of a breakdowns in government and private supervision. In particular, the failure of private parties to undertake sufficient due diligence in making and securitizing high-risk loans was compounded by incentive defects in government supervision. These defects explain the failure to monitor and respond to the safety net implications of decisions by financial institutions to shift leverage and other risks off balance sheet, or to respond to rating organizations inflated opinions about credit quality.

The goal of government regulation and supervision is to manage the costs and benefits of the financial safety net, but this goal can be compromised by clientele pressure. The breakdown of the risk-control process underscores the existence of this incentive conflict in supervision and the tendency of lobbying pressure and regulation-induced innovation to weaken a supervisor's incentives to enforce capital and other prudential requirements on a timely basis. Managers of financial institutions know that reducing the transparency of their claims on the safety net by embedding outsized risk exposures in complicated off-balance-sheet instruments would benefit their shareholders. But they could collect and dividend out profits earned from regulatory arbitrage only as long as they could hide their increased leverage and resulting reputational risks from supervisors and creditors. In tolerating ongoing declines in transparency and the effectiveness of capital requirements, supervisors encouraged the under-pricing of risk; the correction of this mispricing triggered the crisis. The price correction punished three groups: investors who accepted more risk than they wanted, borrowers who overleveraged themselves, and taxpayers who are being made responsible for cleaning up the mess.

Regulators and supervisors have a duty to see that risks can be fully understood and fairly priced by investors. This requires not more government regulation, but an efficient layering of private and governmental disciplines.

In dynamic markets, regulations and their enforcement must be dynamic. They must also adapt to changes in the environment that change their effectiveness. To reduce opportunities for forbearance by regulators, this committee has supported the concepts of the Prompt Corrective Action program (PCA) and Structured Early Intervention and Resolution (SEIR) as specified by the FDIC Improvement Act of 1991 (FDICIA). PCA and SEIR mandate a ladder of increasingly harsh regulatory sanctions. We also recommended expanding the information available to regulators by requiring banks to issue subordinated debt that would be priced by the market. These data would supplement other market and supervisory signals about the financial health of the issuing institution.

The history of conventional depository institution regulation—in terms of its ability to keep these institutions out of trouble—has been dismal. The savings and loan debacle in the late 1980s and early 1990s cost the taxpayers at least $150 billion and was accompanied by the failure of almost 1600 commercial banks. Despite the adoption of FDICIA in 1991, the banking system has sunk again into crisis.

Long before the current crisis, the Shadow Committee recognized that PCA, by itself, was not sufficient to ensure timely intervention to prevent abuse of the safety net and large bank losses. In Statement No. 160, we provided a blueprint for reform of bank capital standards that revolved around a proposal for a minimum subordinated debt requirement for large US banks. The central goal of that proposal was to provide credible early warning of increasing bank vulnerability through a carefully created requirement that banks issue uninsured debt held at arms length. The ability of banks to continue to issue subordinated debt into the market at low yields would provide an indicator of market beliefs about bank risk by entities with "skin in the game," and that signal could be used to inform regulatory policies, including PCA. A minimum subordinated debt requirement was included as a potential regulatory mandate in the Gramm-Leach-Bliley Act of 1999, which required that the idea be evaluated by the Fed and the Treasury. Although a Fed study produced evidence that supported the efficacy of such a requirement, bank lobbying efforts killed the idea.

In view of continuing evolution in financial instruments, the Committee now reiterates to you its recommendation that supervisors draw on additional information about the riskiness of large financial institutions provided by new financial instruments as they emerge. One instrument that promises to be especially useful in helping supervisors to assess risk is the credit default swap (CDS). A CDS provides insurance against defaults of securities that is priced by the market because they trade regularly. While CDS prices are not a perfect substitute for a properly crafted subordinated debt requirement, CDS prices can provide regulators with more current and accurate information on an institution's financial well-being than accounting statements or less frequently traded debt. Signals from the CDS market can alert regulators more promptly of the need to intervene and impose sanctions on floundering institutions.

Another way to encourage prompt use of information from emerging instruments would be to tie compensation of high-level supervisors and regulators to longer-run measures of the quality of their agency's performance in managing the costs and benefits of the safety net and financial innovation.

In addition to improving the regulators' use of information, your administration should ensure that banks and bank holding companies make themselves more transparent to investors, creditors, and counterparties. This goal would be promoted by requiring regulators to develop metrics and indicators of risk-taking that would be published on a regular basis by the regulated institutions. The information provided by these indicators would enable market participants, including investors, creditors, and counterparties to better assess the extent of an institution's risk-taking. In developing appropriate indicators, regulators would be required to consult with analysts and the regulated institutions. Since the indicators would cover the entire banking industry, they would permit a better understanding of the relationship between an institution's risk posture and its profitability, thereby removing the incentive for competitors to take excessive risk.

*Robert Litan recused himself from participation in this statement due to his ongoing work with Obama Transition Team.