Guarding against systemic risk: The remaining agenda

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Underlying assumptions
(from Boston Fed conference, Oct. 2009)

- Finance does not appear to be self-regulating.
- The case for *laissez-faire* in financial markets has been damaged beyond repair.
- The costs of this calamity were huge—probably larger than the efficiency gains from structured finance for decades, maybe forever.
- We won't get rid of TBTF institutions ("SIFIs"), so we have to deal with them.
- Taxpayer interests must be protected.

Top agenda items

1. Resolution authority for SIFIs *(TBTF policy)*
2. Systemic risk monitor/regulator
3. Higher capital *and* liquidity standards
4. Standardize derivatives and trade on exchanges *(will help on KISS)*
5. Dysfunctional compensation systems for traders
6. Role and compensation of rating agencies
7. **Curbs on proprietary trading by banks**

- **Depending on definitions, it's not clear that prop trading played a major role in the crisis.**
- **But maybe it will in the next one.**

Quick review of where we are

1. Resolution authority

- Orderly *Liquidation* Authority is Title II of Dodd-Frank (2010).
- FDIC just issued its "Single Point of Entry" plan.
  - Basic concept: holding company takes the losses while subs (e.g., banks) keep operating as usual. (Could they?)
  - Bank of England seems to be in approximately the same place.
  - But this seems a bit different from the EU's "bail in" approach.
- EU is working to harmonize resolution policies, as step toward Single Resolution Mechanism (SRM).
  - But are we moving down the road?
  - FSB (15 April 2013): "In many countries, resolution authorities currently lack important powers needed to resolve systemic institutions"… including cross-border cooperation

2. Systemic risk regulator

- The news here is good, although "macroprudential" policy is in its infancy
- US now has the FSOC ("Financial Stability Oversight Council"), supported by:
  - Federal Reserve (a new division)
  - US Treasury (a new office)
- Analogous organizations in Europe

3. More capital, more liquidity

- Basel III promises both.
- It's not obvious to me that "capital" was more critical to the crisis than "liquidity."
- Can you tell insolvency and illiquidity apart in a crunch?
- FSB: "good progress is being made" on tangible common equity
- Banks moving there ahead of 2019 deadline
- Big debate: Is TCE standard high enough?
- Progress is slower on liquidity standards: LCR and NSFR

4. Derivative trading

- Pretty slow progress
  - FSB: “much remains to be done”
  - Industry fighting tooth and nail
- By volume, most OTC derivatives are exempt from Dodd-Frank restrictions.
- CFTC just promulgated rules for the rest
  - Not as strong as Gary Gensler wanted
  - NYT editorial last month: “Derivatives reform on the ropes”
- Big debate over “extra-territoriality”

5. Traders' compensation

- Industry has changed practices. How much?
- In US, comp practices are now part of a bank's "risk management" exam.
- The EU seems more focused on pay *levels* than on *incentives*. (Am I wrong?)

6. Rating agencies

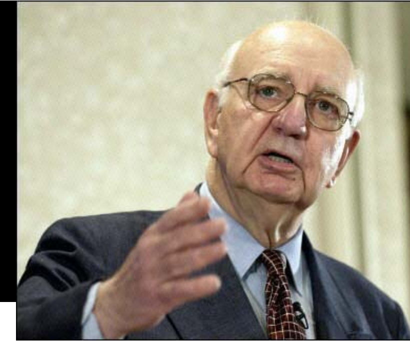
- Two distinct issues:
  1. Requiring use of ratings in laws and regulations (incl. Basel)
  2. How agencies are compensated
- Good progress (in US and elsewhere) on #1
- Virtually nothing has been done on #2.
- Three years after Dodd-Frank and nearly five years after Lehman Day, this is disgraceful.

7. Proprietary trading

- Three approaches (all “cousins”): Volcker, Vickers, Liikanen
- Two possibly conflicting objectives:
- Separate deposits from risky trading
- Keep trading under a regulatory regime (if it leaves the BHC)
- Confession: I proposed something like the Liikanen approach in 2009.

A closer look at the differences

The Volcker rule



- Basic idea: Banks should not use insured deposits to gamble.
- Basic approach: Force proprietary trading out of banks.
  - With some exceptions—e.g., Treasuries.
  - Market-making can stay in.
- Enacted in Dodd-Frank; still waiting for the regs
- Basic problem: “Proprietary” refers to *intent*.
  - Traders may know it; regulators don’t.
- Another issue: It could drive trading into the (unregulated) shadow banking sector.

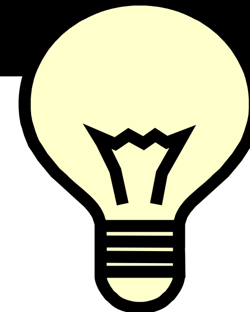
The Vickers ring-fence

- Basic idea: Erect a safety fence around the normal retail and commercial bank.
- Only what's "inside" is protected by the safety net.
- So gets taxpayers off the hook (for trading losses)
- It's not only trading that goes outside the ring-fence—other BHC activities go there, too.
- It is part of the Banking Reform Bill of 2013, which is still pending. (I believe.)
- Another issue: It could drive trading into the (unregulated) shadow banking sector.

The Liikanen "push out"

- HLEG would require separately-funded subsidiaries for (almost) *all* trading
- Including market making
- But "hedged, client-driven" transactions can stay in bank.
- The trading sub can stay within banking group.
- Hence still under regulatory umbrella
- But can parent downstream capital to sub?
- Looks like answer might be "yes."
- Now in EU "consultation period" (until July 3?)

Why I favor the trading-sub approach



- Volcker is right: The safety net should not support gambling.
- But it's nearly impossible to tell proprietary trading from hedging and market-making.
  - So put it all in the sub.
- Disallowing downstreaming of capital from parent to trading sub is important.
  - Trading sub's customers need to know the bank is not behind it.
  - Trading subs would probably need a lot of capital.
- If this pushes trading out of BHCs into hedge funds, is that so bad?
  - Hedge funds use much more MOM (relative to OPM).
  - As long as we regulate any hedge fund that becomes a SIFI.

Overall assessment of progress to date

Only the mediocre are always at their best.

- There has been some, and in some areas a lot.
- But it's not much to show for four years of work (since the acute stage of the crisis ended).
- Worse yet, voters forget while industry participants won't. So bad habits creep back.
- We should do better.