A New Framework for Systemic Financial Regulation:

Simple, Transparent, Enforceable and Accountable Rules to Reform Financial Markets

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Federal Financial Analytics, Inc.

1121 Fourteenth Street, NW
Washington, DC 20005
202-589-0880
www.fedfin.com

Abstract

In this paper, Federal Financial Analytics, Inc. takes on complexity risk – that is, the sum total of all the U.S. and global rules aimed at preventing financial crises like those that still stall job growth and broader economic recovery.

Expressing only the firm's views, the paper does not take issue with most of the reforms – many of them wholly warranted in light of industry and regulatory failures that precipitated catastrophic financial-market risk. However, Complexity risk creates unintended consequences and so much uncertainty that banks have largely headed for the bunker, fearful that the next rule will contradict the last proposal and pose capital, liquidity, legal and reputational risks compounding those already facing the firm under current, tough market conditions.

To solve for this stagnation, the paper proposes discrete capital, liquidity, supervisory, disclosure and corporate-governance reforms that can be readily implemented and easily measured across financial institutions and regulatory agencies. The paper focuses on two fundamental contradictions in the current regulatory line-up:

- banks are being taxed for being too big to fail through surcharges and other rules even though they are then double-taxed in the new U.S. resolution regime to be sure they can fail without taxpayer support; and
- despite lots of talk about "shadow" banks, only banks are facing clear new rules governing both their operations and resolution regime. MF Global is a stark reminder of regulatory inability to plan for non-bank resolutions in cases that threaten markets, a regulatory failure in part resulting from myopic focus on banking organizations. This will surely sow the seeds of the next systemic crisis even as it thwarts the ability of banks to mobilize capital for credit intermediation.

Executive Summary

As the U.S. crisis drags on and the European one threatens what recovery there has been, Federal Financial Analytics looked with increasing worry at the sheer volume of regulatory action and the unintended consequences sure to come from the sum total of all of them. We have concluded that what we call complexity risk – the burden on financial institutions and regulators of complex, cross-cutting and sometimes incomprehensible rules – may well now be the most significant impediment to financial-market recovery and robust economic growth. This is a most ironic result given the merits of many of these new rules, and it is thus imperative to quickly identify a clear, simple course to reformed financial-institution regulation that imposes discipline where needed without serving as an impenetrable blanket on market recovery.

This paper[1] is FedFin's own assessment of complexity risk resulting from all the new rules. More to the immediate point, it is also an assessment of alternatives to the sum total of all of these rules that would, we believe, provide appropriate prudential regulation for individual financial institutions, subject regulators to more transparency and – most importantly – mobilize real market discipline invigorated by a sure knowledge that risk taken is risk absorbed. The paper assesses the fundamental contradiction between rules aimed at regulated firms, especially big banks, on grounds that they are "too big to fail" at the same time that new resolution regimes, especially in the U.S., ensure they are not.

Regulators often proceed on each reform as if it is the only one under way. Similarly, institutions, academics, consumer advocates and analysts often assess the rules in each "silo," looking at them from specific perspectives of individual goals or defined agendas. This paper attempts to assess major initiatives in concert with each other and, then, in light of broader market developments, to provide an integrated framework of balanced reform to position financial markets and banking organizations to resume their critical micro- and macroeconomic function. FedFin's key recommendations are:

- **Regulatory Capital**: We concur with the thrust of the changes to bank capital, including the Basel III hikes to capital ratios and changes to ensure that capital instruments in fact fulfill their function as risk-absorbers. However, we note that the Basel III rules, like Basel I and II, will do little to address real financial-market risk

[1] There are few footnotes in this paper as most references are to well-known and widely-available public documents. Citations are provided where less well-known material is cited. Questions about other material referenced herein may be referred to INFO@FEDFIN.COM, with citations then readily provided.

without significant accompanying reform. This includes enhancing the transparency of the risk weightings on which the Basel standards are based, and we are indebted to a proposal from the chief executive officer of Citigroup, Vikram Pandit, for a benchmarking concept we detail below. We also propose ways to ensure a more uniform capital framework so that critical credit-intermediation functions and related market activity do not migrate from banking organizations due to the sheer weight of the new capital rules and all the other standards piled atop them.

- **Board/CEO Responsibility**: We propose three major changes here in lieu of the increasingly burdensome, ineffective standards imposed in the name of enterprise-wide risk management and corporate governance. First, there should be a top-level, expert risk-management committee comprised of board members. Second, directors, CEOs and/or other top managers should attest to certain risk-related findings, but only to those truly germane to franchise or systemic risk, not to the minutiae now contained in numerous attestation requirements. Finally, the board should set "risk tolerances" and attest to the degree to which they were followed or any corrections undertaken when tolerances were transgressed.

- **Liquidity**: All regulators – not just banking agencies – should identify key drivers of liquidity risk under time frames germane to ordinary, stress and catastrophic risk conditions. Ratios such as those in the Basel III standards can be used to assess risk, but should not now be used to stipulate regulatory action because the factors contributing to liquidity risk are still only partially understood, especially across national borders.

- **Market Discipline**: This paper includes a detailed set of disclosures designed to make both financial-institution operations and regulatory judgments more transparent through simple disclosures standardized across industries and regions. Markets also provide clear-eyed assessments of counterparty risk; we here detail those we think can be readily disentangled from "noise" (e.g., CDS-trading spikes) to guide regulators to rapid intervention at individual institutions or on a macroprudential basis.

- **Resolve and Relief**: After assessing rules under the three Basel "pillars" briefly outlined above, this paper proceeds to a fourth critical criterion by which all of the "microprudential" and "macroprudential" standards should be judged: whether a financial institution that takes risk reaps the consequences of its actions or if taxpayers, depositors or other innocent bystanders back it up. Some of these backstops are long-established and well understood (e.g., U.S. deposit insurance, central-bank liquidity facilities) and any institution with access to them requires substantive regulation in tandem with government limits to prevent moral hazard resulting from these safety nets. If there are direct or indirect safety nets that promote market expectations of "too big to fail," then surcharge regulation is warranted to tax institutions for this benefit. But, if there is no such backstop – which

now is banned in the U.S. – then regulation should be limited to specific purposes. There should be no double-taxation, charging firms (e.g., large U.S. banks) once for their prudential framework and, then again, for the cost of ensuring they are readily resolvable without taxpayer support. If ready recovery/resolution is deemed impossible – an unproved assumption – then firms that pose systemic risk should be regulated as utilities, not subject to the contradictions of complexity risk.

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Federal Financial Analytics, Inc. has provided objective analytics and advice to major financial firms in the U.S. and around the world since 1985. A list of clients may be found on the firm's website, www.fedfin.com; clients have also included major regulatory bodies in the U.S., U.K. and other nations. The firm provides advisory services that focus not only on transactions with significant policy ramifications, but also on matters of legislative, regulatory and policy advocacy clients may wish to undertake. In general, the firm does not represent clients before regulators and it does not lobby the U.S. Congress or the executive branch. The views expressed in this paper are purely those of the firm and its managing partner, Karen Shaw Petrou, and do not necessarily represent those of any of the clients they advise on matters discussed herein.

I. Introduction

Since 2008, national and global regulators have sought to correct the errors that precipitated the financial crisis, advancing sweeping revisions to the framework of financial-institution and market regulation. Many of these are warranted; indeed, critics (including Federal Financial Analytics[2]) called for change before the crisis made clear how urgent it was. However, the sum total of all these post hoc corrections – revising capital, liquidity, resolution, activity, "ring-fencing," consumer-protection, deposit-insurance, securitization, and many other requirements in the U.S. and around the world – has created a concatenation of complex rules with cross-cutting effects that – despite the important needs that underlie many of these actions – combine to create undue cost and unintended consequences.

The industry has taken on each of these reforms, frequently going beyond pure protest to offer constructive changes. However, the sheer volume of all these reforms and the magnitude of the resulting strategic redefinition have also often led the industry to focus on each of these rules in "silo" fashion. Regulators have done the same, with each of these initiatives proceeding from separate agencies or "working groups" that often fail to take fully into account the sum total of all of these actions.

A major underlying view in this paper is that complexity in regulatory action is almost always the result of over-engineered standards that come years too late because details take far too long to finalize to the satisfaction of all of the experts deliberating on them. Worse still, after these hundreds-plus page proposals are finally sprung from the interagency and/or international working groups that preside over them, political compromises soft-pedal parts of the rules or limit their reach so that even the architects of the original rules despair of their results without being able clearly to anticipate what the new, compromised standards will do.

A classic example of this type of complexity risk is the capital regulations that, even now, govern Fannie Mae and Freddie Mac. Ordered by Congress in 1994 to set risk-based capital standards for these government-sponsored enterprises (GSEs), their regulator took seven years to issue a rule that took hundreds of pages and dozens of complex formulas. Persuaded that it understood the inter-relationship of credit and interest-rate risk, the regulator allowed risk mitigants in each of these areas (largely derivatives judged by rating-agency grades) to offset each other. As a result, highly-correlated risk positions in fact resulted in sharply lower risk-based capital, with the GSEs on numerous occasions actually scoring a zero risk-based capital requirement. This led the GSEs' regulator not only to trumpet the GSEs condition, but also even to permit them to distribute capital up to the point in 2008 when, sadly, the GSES were put into conservatorship at the start of the global financial crisis they helped to spawn. Had the risk-

[2] See the Federal Financial Analytics site, WWW.FEDFIN.COM, for speeches, testimony and other public material from the firm addressing the issues discussed in this paper.

based capital rules been far more simple and clear and had they been imposed in conjunction with other prudential standards (sensible leverage rules, corporate governance requirements, etc.), Fannie and Freddie would surely have survived to promote U.S. recovery instead of making it still harder.

Here, we assess the new regulatory framework from a strategic perspective. Then, we propose a new approach that does not oppose many of these reforms, but rather subsumes most of them into an over-arching, simple framework of market-driven signals and transparent analytics that permit banks, consumers, counterparties, investors and regulators to make a straightforward, forward-looking judgment about financial risk. Along the way, we also suggest simple ways to judge regulators and their acumen so that the entire burden of this new framework is not borne solely by financial institutions. With all the best will in the world and the most diligent risk management possible, banks simply cannot be expected to safeguard the interest of their home-country financial systems and, still harder, that of the global market if regulators do not also hold themselves accountable for effective supervision and rigorous enforcement.

II. Regulatory Landscape:

The Sum Total of National and Global Financial Regulation

Space does not here permit an exhaustive study of all pending regulatory reforms, a review that would also prove exhausting given the scope of all the actions now under way or proposed by regulators in financial centers (e.g., U.S., U.K. and the European Union) and the global bodies seeking to set over-arching international standards (the Basel Committee on Banking Supervision, international securities and insurance agencies, the Financial Stability Board and the International Monetary Fund chief among them). However, all of these initiatives fall under two broad rubrics: "microprudential" changes aimed at prudential governance of the operations of individual firms – and "macroprudential" rules that seek to stabilize national and even global financial systems and, thereby, prevent macroeconomic stress.

A short summary of major actions under way in both the micro and macro prudential arenas is provided below, focusing not on a description of each, but rather on a summary assessment of how each action cross-cuts the others. The goal of this analysis is not to fully analyze each of these regulatory initiatives in detail, but rather to substantiate the assertion that the body of all of these actions is growing so large that its sheer weight will have unintended and adverse implications on financial stability and economic recovery.

A. Major Microprudential Initiatives

1. Capital

Historically, global and national regulatory frameworks for financial institutions (banks, insurers and securities firms) have been largely focused on regulatory-capital standards. These vary widely across sectors, but the principal initiatives here are the new Basel III regulatory-capital standards for banks and the Solvency II ones for global insurers. The U.S. also sets net-capital rules for broker-dealers and has recently focused on leverage as a leading indicator of systemic risk for nonbank financial companies (e.g., asset managers, hedge funds). Global regulators have also singled out capital as the first attack on systemic risk, proposing a significant "surcharge" for global systemically-important banks (G-SIBs) and suggesting that a similar add-on capital requirement might apply to other large financial institutions (although sectoral regulators for these non-banks to date have strongly opposed any such surcharge).

All of these rules have become increasingly complicated and are likely to become even more so as U.S. regulators comply with new law mandating removal of rating-agency designations from capital standards and global regulators seek to do the same. However, key cross-cutting and problematic provisions in the emerging capital framework include:

- Undue reliance on sovereign debt as a "risk-free" asset, a provision in the current capital regime that has exacerbated the EU crisis and is made still more problematic by the reliance on these assets on which the liquidity rules (see below) are premised;

- Correlation risk for the financial system, which results because the capital rules create incentives for banks and insurance companies to hold the same assets. This means that stresses in the financial system are similarly experienced by regulated institutions, potentially turning stress at one or another firm into a systemic shock;

- Complexity arbitrage, in which some banks under-estimate risk when setting the capital "weighting" for instruments. Again, this was evident in the EU crisis and is a major risk as emerging nations (e.g., China) with lax supervisory frameworks become systemic participants in global financial markets; and

- Incentives for risk to migrate from regulated institutions to shadow ones. Advocates of stringent capital, including surcharges for G-SIBs, argue that the adverse impact of these rules is largely offset by reduced cost of capital to more stable banking organizations. However, evidence to date (i.e., U.S., EU) indicates that banks cease to do certain lines of business when they believe regulatory capital is disproportionate to risk and, thus, not viable if reasonable return to investors is to continue.

As noted, this list of problems is not intended to argue against substantive reform to the regulatory-capital regimes governing banks, insurers, securities firms and other regulated financial institutions or to critique the specifics of pending initiatives. Many of these proposals are warranted, but their sum total presents the combined problems highlighted here.

2. Liquidity

Liquidity risk has been acknowledged for centuries as a cause of financial panics – the reason governments created central bank backstops and, in the U.S. and a few other nations, deposit-insurance schemes. However, all of this liquidity-risk insulation is focused on banking organizations, proving sadly inadequate when systemic risk arose at nonbanks like Bear Stearns, AIG and Lehman Brothers. Further, critics of these measures contend that, even though they protect bank counterparties and depositors, banks do not take sufficient care to ensure that they can operate in a prudent fashion so that calls on government facilities are made only in circumstances so far beyond a bank's control as not to constitute moral hazard.

Reflecting this, the Basel Committee has finalized a new liquidity-risk framework with mandatory risk-control ratios that national regimes are now beginning to put in place.

Again, we do not quarrel with the underlying premise of the liquidity rules or with numerous aspects of them. However, problematic cross-cutting concerns include:

- The bank-centric nature of the rules, which creates the arbitrage and shadow-banking issues noted above with regard to the capital framework and is perhaps even more problematic here given the proven role of liquidity risk in nonbanks in the current crisis;
- Reliance on unproven ratios that correlate liquidity risk in the few asset categories – e.g., sovereign debt – not penalized;
- The interaction of the liquidity and capital rules with national accounting standards, which create significant international asymmetries and balance-sheet volatility; and
- Altered financial-market incentives that exacerbate systemic risk in money-market mutual funds (where reform remains largely unaddressed despite widespread regulatory agreement on its need).

3. Orderly Resolution

Despite the capital, liquidity and other regulatory initiatives under way, concern remains that large, complex and cross-border financial institutions cannot be resolved in an orderly fashion, creating both systemic risk and likely cost to taxpayers as large firms take advantage of anticipated support to become "too big to fail" (TBTF). To address this, the United States adopted Title II in the Dodd-Frank Act to create a new "orderly-liquidation authority" for systemically-important financial institutions (SIFIs), a regime premised on bankruptcy (although the FDIC is given authority to intervene in limited ways to stabilize markets, but not rescue institutions or counterparties, in the event of systemic risk). The FDIC and FRB have also finalized "living-will" requirements for SIFIs to ensure that these firms contemplate their end, plan for it and, then reassure regulators as to their ability to be handled under bankruptcy and not call on taxpayers for aid.

Resolution initiatives are in a far less-certain state outside the U.S., although the Financial Stability Board has issued a consultative paper aimed at all global SIFIs, not just banking organizations. This effort will advance with additional requirements, especially with regard to living wills, but its practical impact is at best uncertain due to the simultaneous work by the EU to craft an array of taxpayer-supported rescue facilities for banks. Contradictions and concerns raised by this effort include:

- The contrast between capital and liquidity standards, especially surcharges for big banks, based on the “negative externality” of taxpayer rescue that is now barred in the U.S. To be sure, skeptics question the degree to which U.S. regulators would in fact meet the new law’s requirements, but building regulatory requirements based on this skepticism will in fact create the perverse result of reinforcing TBTF, not ending it;

- The asymmetry resulting from the U.S. regime, which is buttressed by substantive and costly rules that expose creditors, shareholders and counterparties to risk and the global regime that, despite the FSB consultative paper, is based on TBTF. This could lead to a migration of financial activity outside the U.S. to these “safe havens.” U.S. regulators acknowledge this danger, although they defend the stringent U.S. resolution regime on grounds that investors and others will prefer it due to the rules that protect them from the almost-certain losses should a SIFI falter; and

- The wide variation in resolution regimes for different types of financial institutions. The Dodd-Frank Act covers SIFIs, not just banks, and the FSB effort hopes to do the same. But, in fact, standards to date are largely crafted for banking organizations, resulting in significant uncertainty and risk when doing business with nonbank financial companies.

4. Corporate Structure

Regulators have concluded that interconnectedness and complexity are driving systemic risks, and include them in the criteria that dictate additional rules like the bank capital surcharges noted above. However, additional initiatives are also either under way (e.g., requirements for U.K. banks to separate retail from investment banking) or contemplated. In the U.S., for example, the living wills noted above, especially those mandated for large insured depositories, may well pressure U.S. institutions to segregate their U.S. banking operations from offshore ones now housed in host-country branches. At the same time, U.S. regulators are exploring ways to ensure that branches of foreign banks operating in the U.S. are adequately capitalized and sufficiently liquid to absorb risk here despite the stressed condition of their parent bank – a move that may effectively ring-fence these U.S. operations. Many of them are also subject to new U.S. requirements – for example, the U.S. rules on resolution plans apply to any foreign bank with a branch in the U.S. if its total global assets exceed $50 billion regardless of the size of the U.S. operation.

Other pending regulatory initiatives also affect the degree to which SIFIs, especially banks, can integrate their global operations. For example, U.S. law includes extensive restrictions on the degree to which a firm may engage in inter-affiliate transactions (Sections 23A and 23B of the Federal Reserve Act, which will be tightened under rules required by the Dodd-Frank Act). New

U.S. rules will also more tightly define counterparty credit risk (CCR), expanding the classes of credit risk subject to what once were called “loan-to-one-borrower” restrictions.

Issues here include:

- The degree to which banks should be required to separate retail and investment banking operations if top-tier regulation (e.g., capital rules) applies despite the new protection for depositors and taxpayers resulting from inter-affiliate transaction and activity constraints. The hived-off investment banking and similar operations are subject to bank-like regulation if still within a banking organization even if they compete directly with shadow institutions in these non-traditional sectors not subject to comparable standards. This may reduce risk to bank regulators and customers, but not necessarily in the financial system absent broader systemic regulation (fragmentary outside banking, as noted above); and

- The degree to which ring-fencing makes the separated parts of complex organizations more, not less, risky. In branch operations, firms can readily transfer capital and liquidity to support stress at host- or home-country activities. With legal impediments, this is more difficult. The higher costs resulting from fully capitalizing and funding activities previously housed in branches will also strain profitability in these ring-fenced entities, likely leading banks to shutter activities that may be valuable to the efficiency of host-country regimes and smaller customer segments, as well as useful to promoting credit availability and economic growth.

5. Other Strategic Regulatory Microprudential Initiatives

Space does not permit a full discussion of the inventory of other pending microprudential initiatives in the U.S. and global regimes. Key actions and possible consequences include:

- **Risk Retention**: The U.S. is considering rules that would require securitizers to hold a substantial position related to any securitized loan and similar risk positions. The EU has a similar requirement, but that market is not as dependent on securitization. In the U.S., secondary markets accounted for fifty percent of credit availability before the crisis, with this now far higher (i.e., ninety percent) in mortgage finance. Risk retention is intended to align securitizer incentives with regulatory ones and those of borrowers, but imposing this in conjunction with the higher capital and liquidity rules cited above could choke off credit availability in affected sectors.

- **Volcker Rule**: Limits on proprietary trading and investments in hedge/private-equity funds are changing the wholesale-banking model in the U.S., forcing affected banks back to traditional banking services that are, at the same time, coming under all the rules cited above. The final shape of the complex Volcker Rule is at best unclear, but U.S. banks have already begun to refine their strategies (i.e., by shedding what is clearly proprietary trading and divesting certain investments). Remaining activities will be adversely affected by the new capital rules (including pending revisions to those covering a bank's trading book), empowering the nonbank investment-finance franchise absent rules governing it. The shadow-bank standards referenced above are supposed to prevent this by limiting bank support of nonbank firms, but it is at best uncertain if bank financing is so vital to nonbank financial services, especially if major non-U.S. markets do not similarly constrain activities subject to the Volcker Rule (so far, unlikely).

- **Derivatives**: U.S. and global regulators are seeking to drive as much over-the-counter (OTC) derivatives activities as possible into central counterparties (CCPs). This is changing the structure of OTC derivatives in ways that may constrain bank profitability and concentrate systemic risk in these new CCPs before regulators develop a robust regulatory framework for financial-market infrastructure (e.g., payment-and-settlement service providers). Regulators have begun to craft the framework for what the U.S. calls "financial market utilities," seeking to create new systemic rules to address concentration risk and new authority for CCPs to use the FRB's liquidity facilities. However, these rules are in a very early stage in the U.S. and still less advanced abroad.

- **Consumer Protection**: To date, the bulk of rules in this sector are found in the U.S., which has imposed new price-caps on debit-card interchange fees, limits on overdraft fees, standards for mortgage loans and the like. However, in the wake of a recent scandal involving bank cross-selling of credit-protection policies, the U.K. is also developing a stringent new consumer-protection regime. Global standards to date have otherwise been largely rhetorical. Substantive consumer rules (especially with regard to pricing) change the business model in affected bank products and also create strong incentives for unaffected providers (e.g., through on-line and nonbank channels) to offer proxy services that mimic bank products, but are exempt from regulatory restrictions.

- **M&A**: In the U.S., the Federal Reserve has launched an unprecedented review of large-bank transactions in conjunction with the Capital One/ING deal. Similar limits are not yet evident outside the U.S., but may well surface in conjunction with the G-SIB surcharge and growing worries about the disproportionate size of banks in certain nations. This will limit the degree to which other financial institutions will be willing or able to acquire strategic divestitures from stressed banks, as well as the amount of private capital willing to invest in banking organizations. The less private capital at hand for these transactions, the more public capital will be required.

B. Macroprudential Regulation

This is a far less certain arena for global regulators despite extensive supervisory and academic discussion of ways not just to ensure that each SIFI is sound, but also to prevent contagion risk within the financial industry from migrating to the macroeconomy. Indeed, numerous official and academic papers have posited an array of factors as leading indicators of macroprudential problems or early warnings of systemic risk, although these studies are still in the early stage of research and peer review.[3] Reflecting the initial consensus on macroprudential indicators and the parallel uncertainty about just what these are, regulators are positing an array of data "templates" that require a formidable range of reports on both broad positions (e.g., concentrated credit risk) and granular ones (e.g., real-time derivatives positions).

Still, the uncertainty about macroprudential indicators and the broad reach of data-reporting standards have not stopped regulators from proposing and, in several cases, finalizing macroprudential measures. Macroprudential measures in place or well advanced include:

- **Counter-Cyclical Buffers**: The Basel Accord includes add-on capital charges linked to asset prices in relation to GDP. However, as even regulators acknowledge, the link between this driver and actual macroeconomic risk is uncertain. Nor is it at all clear which nations would in fact impose this capital charge if conditions appeared to warrant it. Thus, even though this capital charge is hypothetically final, regulators are exploring additional capital requirements linked to factors like the loan-to-value ratio of residential mortgages.

- **Stress Tests**: These requirements have microprudential implications, as results are supposed to drive supervisory action at individual firms (e.g., a ban on capital distribution). However, stress tests are also supposed to provide regulators with an early warning of correlated institution, market and national trends in the financial sector that may adversely affect macroeconomic stability. To date, stress tests have applied only to large banking organizations and, even then, have had real impact only in the United States.

- "**Horizontal" Supervision**: Led by the FRB in the U.S., this effort attempts to assess not just individual institutions in their own idiosyncratic right, but also compare them against each other to identify outlier institutions. However, this approach has yet to capture nonbanks, non-U.S. firms and/or to understand the degree to which outliers may in fact signal emerging best practice, not systemic risk, because the correlation among most large banks in the horizontal sample may mask emerging macroprudential problems.

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[3] BIS Working Paper, *Rediscovering the Macroeconomic Roots of Financial Stability Policy: Journey, Challenges and a Way Forward*, (Sept. 2011) *available at* http://www.bis.org/publ/work354.pdf.

While more than formidable and in many ways still under construction, this list is less daunting than the actual construct of macroprudential rules some regulators now contemplate. For example, the top financial regulator in the U.K. has suggested that:

> "We may need to consider prudential tools which lean far more aggressively than in the past against the proliferation of intra-financial system complexity, the use of balance sheets to support inter-bank position-taking ... And we may have to consider using macro-prudential levers which apply at the level of ring-fenced banks …focused solely on core services to the real economy."[4]

In this vision of macroprudential regulation, very large banks would be bound far more tightly than required by even the ring-fencing, Volcker and similar rules outlined above. In essence, these banks would be converted into the equivalent of utilities, limited to defined tasks to promote social welfare under stringent safety-and-soundness criteria that may or may not provide investors with a reasonable rate of return.

Reflecting the global recession – a near-depression in many nations – following the financial crisis, central banks are also reconsidering their focus on price stability as the core criterion of monetary policy. Extensive work is now under way in many central banks, including the U.S. Federal Reserve and the Bank of England, not only to undertake new financial-industry supervisory duties, but also to recalibrate monetary policy to achieve macroprudential goals.

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[4] Adair Turner, Mansion House Speech (Oct. 20, 2011) *available at*: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/1020_at.shtml.

III. A Market-Driven Solution

Given the panoply of regulator-driven “solutions” to financial-institution and market risk, only a detailed discussion of each of these would balance all of the pending actions and, then, cut through them to a more unified theory of financial reform. This paper does not attempt that. However, based on the proverbial three pillars of the global bank supervisory framework – capital, supervision and market discipline – this paper proposes revisions, replacements and simplifications to these rules to focus both regulatory and industry attention on initiatives that, we believe, address high-risk practice with high-return government intervention.

There is one more pillar we add to the Basel framework because the capital, supervisory and market-discipline framework works only if buttressed by one additional discipline: risk of loss when mistakes are made. This ensures that markets discipline not just themselves, but also regulators, because information will rise from risky decisions to alert governments not too somnolent or captive to take note. If they are, then transparency along simple, clear indices (described below) will alert investors to regulatory havens of uncertain stability, creating a flight to safety that will reform laggard regimes.

The goal of all of the regulatory actions below is to make financial markets less vulnerable to shock, bolster individual financial institutions (especially banks and others backed by taxpayer facilities) and – for good measure – make supervisors more accountable for their actions. As the rules outlined above make clear, the pending edifice of reforms is so complex that, even if it collapses of its own weight and sparks a renewed macroeconomic crisis, regulators can easily blame others because no one will fully understand either all these rules or whether any of them were ever enforced.

A. Capital

Leverage is clearly a perverse incentive to microprudential behavior because it permits financial-institution management to bet with other people’s money – depositors backed by the FDIC or similar backstops, taxpayers when TBTF is anticipated or hapless investors when duped into handing over the cash. If enough ownership capital is at risk in tandem with the investment of outsiders, history teaches that microprudential risk is reduced. It is not, however, eliminated because all of the regulatory-capital schemes adopted to date have embedded flaws. These have permitted banks to arbitrage the standards (e.g., by leveraging off-balance sheet risk under Basel I or doubling-down in sovereign risk under both that regime and Basel II). Complexity has also compounded the risks in the bank-capital regime because banks have grown adept at taking risk not well captured by risk weightings, especially when regulators

condone such practices. The asymmetry between bank-capital standards and those applied to other financial sectors (where applicable) also promotes arbitrage outside the banking sector when comparable products are on offer.

Key facets of the solution to this problem are:

- **Keep It Simple**: Avoidance of complex instruments as a form of qualifying regulatory capital. If investors wish to view intangible instruments, accounting adjustments or other changes as a form of capital, so be it – indeed, several of these factors in fact do create robust risk insulation and/or reduce balance-sheet volatility. However, regulators should rely only on retained earnings, common equity and a limited class of comparable instruments. A simple minimum capital-to assets ratio (including both on- and off-balance sheet assets) should be imposed to offset model risk, regulatory errors in risk weightings and similar factors. However, because leverage permits adroit risk arbitrage, all financial institutions using risk-weighted capital should make public their calculations of regulatory capital against benchmark asset positions. Sectoral reports comparable to the U.S. call reports for banks should average these weightings and provide medians on them so that markets and regulators have macroprudential indicators of capital trends and can also assess individual institutions against peer groups.

- **Counter-Cyclical Requirements**: In the U.S., private mortgage insurers (MIs) are required to house half of every dollar of premium revenue in a catastrophic reserve for ten years. This is an extreme example of dynamic provisioning, but it served to preserve the industry through three years of the most acute housing depression in U.S. history. To be sure, several U.S. MIs are now in "run-off," but even so this catastrophic reserve has assured robust claims-paying capacity unparalleled by banks, government-sponsored enterprises or other firms with comparable residential-mortgage exposure. Current proposals for counter-cyclical capital buffers are, as noted, largely based on unproven indicators. A simple and more proven approach is to ensure ample reserves (loan-loss or the equivalent) based on stress-test scenarios incorporating the full range of risk (credit, market, operational and the like). Many of these risks (e.g., operational) do not fit current capital models, and counter-cyclical stress testing should thus give ample credit to risk mitigation (e.g., insurance in a first-loss position).

The more complex a financial institution, the more of these risks it needs to capitalize. However, just because a firm is small or simple should not excuse it from robust capitalization. Thus, exceptions to capital rules based on regulatory status or size should be limited, if provided at all. To control against risk arbitrage from regulated to unregulated shadow firms, regulated institutions (i.e., those with deposit insurance, central-bank access or other taxpayer-supported backstops) should have stringent inter-affiliate transaction restrictions to bar transmission of government benefits to un- or under-regulated affiliates and to limit risk concentrations. Simple

risk-concentration limits will be a major safeguard here, including with regard to preventing undue uncapitalized concentration in “risk-free” assets like sovereign or agency debt.

B. Supervision

The Basel framework is vague in many respects even as it rightly urges bank regulators to buttress quantitative capital standards with additional prudential measures and qualitative reviews. Here, we identify several critical supervisory determinants of safety and soundness across the range of financial institutions, briefly describing simple criteria that can be readily understood by both regulators and the financial market.

- **Board and Senior-Management Responsibility**: Statements leading up to the crisis, and a blizzard of them now, tout the need for enhanced enterprise-wide risk management and the appropriate “culture” at complex financial institutions. These are buttressed in the U.S. now by a statutory requirement that SIFIs have risk-management committees of the board, a requirement that should quickly be adopted by the FSB for all global SIFIs. In mandating risk-management committees, regulators should also stipulate that members have applicable experience and consider the degree to which this in fact exists when examining corporate-governance practice. When a SIFI is not subject to such examination, then applicable securities law or, failing that, best practice, should dictate public disclosure so that markets can assess the seriousness with which risk management is in fact taken by the firm at the top-tier level.

- **Attestation**: In the U.S., attestations by boards and/or senior management as to compliance with various rules has become an increasingly popular double-check on firm compliance. In general, these officials strongly oppose attestation on grounds that it sharply increases personal legal risk because of the complexity of the findings requiring attestation, many of which address specific details on complex rules that would not ordinarily rise to the board, CEO or CFO’s attention. However, the principal of attestation – essentially forcing senior decision-makers to put their money where a firm’s mouth is – is sound and should be advanced in concert with limiting attestations only to matters germane to board and senior-management knowledge, judgment and responsibility. If attestations are properly calibrated, they also serve to protect the board and senior management from subsequent liability. The details of these attestations should not be made public, but their fact should be so that markets can assess the degree to which firms are meeting applicable standards, even if they do not apply to SIFIs not governed by the hands-on supervisory system applicable to most banks.

- **Risk Tolerances**: Senior bank supervisors from around the world have cited risk-tolerance levels set by boards of directors as critical controls, and we concur. Management should identify key business lines, risk parameters in each and – importantly – correlations between them. Then, the risk-management committee (see above) should decide how much the firm is willing to risk in relation to capital, liquidity and other resources as well as with careful consideration of unquantifiable risk (legal, operational and reputational). After the risk-management committee has set detailed risk tolerances, the full board should be presented with them in clear, measurable and testable fashion so that tolerances can first be approved and, then, monitored in an enforceable fashion.

1. Liquidity

As discussed above, solvency risk – which regulatory capital aims to curtail – is not the only source of systemic risk. Getting caught short when unfunded claims are called is clearly another hazard, especially for firms without direct access to central-bank liquidity facilities. To counter this risk, the Basel Committee added a new set of liquidity rules to the Basel III framework. As noted, these are bank-only, complex and ratio-driven standards, derived from at best uncertain empirical work and limited forward-looking quantitative assessment by global regulators. The rule also poses significant potential conflicts with the global capital standards, as well as with numerous other initiatives (e.g., the U.S. Volcker Rule) and applicable accounting standards.

As is all too common with static rules, the Basel framework picked two time periods that, while important, do not always drive systemic risk (see, for example, the overnight-funding shortages that felled Bear Stearns and Lehman Brothers). To address this, a simple, yet powerful, approach to liquidity risk is for regulators – not just banking ones – to identify key drivers of liquidity risk and the timeframes of most concern under ordinary, stressed and catastrophic scenarios. Best practices to address risk under each of these scenarios should be promulgated, along with supervisory ratios that guide liquidity-risk management, but do not dictate it to avoid arbitrary, static standards. Firms would be supervised for compliance with best practices and be required to disclose both best-practice results and how each fared under the applicable ratios – explaining both to markets and regulators why any divergence is not a material risk consideration that warrants response.

Over time, this supervisory framework could be built into specific, binding ratios. However, it is far too early to mandate this for banks, especially in light of all the other pending rules that exacerbate complexity risk and the likelihood of regulatory arbitrage outside banking into sectors wholly exempt from any sort of liquidity regime, let alone the robust one outlined above.

2. Activity Limits/Ring-Fencing

These restrictions, outlined above, are largely premised on the view that risk will transmit from speculative or otherwise inappropriate activities in a complex SIFI to threaten individual depositors or other “innocent bystanders.” These rules also seek to reduce the difficulty regulators face when resolving a complex firm by isolating activities either by their nature or by the geography in which they are located so that risk cannot spread from one entity to another to challenge home- or host-country regulators without the power to reach beyond an activity or national border.

These concerns are all too real, as the financial crises of the last few years demonstrate. However, if all the clear, simple rules outlined above are combined with the ready-resolution arsenal discussed below, then the odds of contagion risk are radically reduced and, with that, the need for arbitrary dividing lines between activities or geographies. Only if these rules prove fragile or if regulators are unable to enforce them should regulatory dictates that override business rationale be considered. For now, it’s too soon and based on unproven hypotheses.

C. Market Discipline

This Basel “pillar” is principally composed of disclosures that banks are to make so that investors, counterparties and others put at risk by what a bank may do have access to information that, at the least, gives them a heads-up. However, these disclosures – also mandated by the Basel II Accord – have to date done little to protect systemic institutions because:

- They only apply to banks;
- They are imperfectly imposed by home- and host-country regulators;
- They vary dramatically based on applicable accounting regimes; and
- They are really, really hard to read.

Thus, the admirable principle of market discipline based on symmetric information between SIFIs and customers is, at best, in the works. To advance it and to subject regulators to the same discipline they advocate for their charges, substantive reforms include:

- **Regulatory Transparency**: We have long advocated disclosure of the “CAMELS” ratings by which U.S. bank regulators judge insured depositories, along with the similar ratings used for holding companies. Regulators have vociferously opposed this idea for at least as long, joined by banks who fear that disclosure of any

unfavorable views from a supervisor would spook their customers. But, so it should. And, all too often, ratings by regulators are far off the mark. Had they been disclosed, markets would have seen quickly how wrong the U.S. Office of Thrift Supervision was about its charges, knowledge which would have dissuaded the false comfort many took in the presence of a "supervisor." Better still, strong institutions might have better resisted the temptation to ape high-flyers in ways that took a microprudential problem and turned it into a profound macro one.

- **Systemic Reporting**: Global regulators have made good progress with one critical missing data-point: a legal-entity identifier (LEI). Before proceeding to demands for thousands of other data points of often uncertain relation to systemic risk, global regulators should complete the LEI project. Further the systemic indicators included in the new FSOC rule for nonbank financial companies – transparent criteria for at least initial systemic screening – should either be adopted by global regulators or replaced with a similar set of no more than ten observable factors from which qualitative systemic assessment can proceed. Simply demanding a deluge of data from banks in hopes that this will then guide supervisors to broader SIFI worries is not only likely to prove a waste of supervisory time, but also in fact a counter-productive exercise because of the valuable resources diverted from the urgent resolution-plan focused data projects discussed below.

- **Market-Derived Risk Indicators**: We see two critical issues here – ensuring that regulators listen to those who may see early warnings before regulators or learn from listening only to those they govern (not usually the most objective analytical sources). As we survey the advisory committees set up by national and global regulators, we are struck by how many of them consist solely of other regulators in the same sector or regulated institutions. Had U.S. regulators listened not just to mortgage lenders in the run-up to the subprime crisis, but also to mortgage insurers and risk counterparties, they would have heard distinct early warnings of behavior that profited banks and related parties (e.g., rating agencies) so generously that dissent from within the industry was scarce and concern within some regulatory agencies discounted. Secondly, several market red flags exist to guide regulators to all large financial institutions that pose risk. The most important of these are market capitalization – when investors think ill of a firm, it's usually for cause when stock price declines are prolonged; when investors think so highly of a firm or sector that prices rise without relation to underlying earnings or demonstrable fundamentals, regulators should again take heed of a significant macroprudential warning bell. Credit-default-swap pricing is also useful, but trading noise distorts its value as do market structures (e.g., "voluntary" default) that impose risk without triggering CDS-payment risk efficiently translated into CDS pricing. As noted above, research is under way on other macroprudential indicators, and this should be accelerated – especially when related to transparent market drivers that do not impose new burden on SIFIs – and then reflected in new, clear statements about which indicators will be watched and what will be done when the red flags wave.

D. Orderly Resolution without Taxpayer Support

This last criterion for effective SIFI regulation is not in the Basel framework, but it is a clear factor by which all industry-regulatory proposals should be assessed. The U.S. has set in both policy and law the maxim that taxpayers are not to support banks or other financial institutions, as well as barring bail-out for SIFI creditors, counterparties, shareholders or management. Most other major financial-market nations have a similar hope, most recently expressed in a sweeping consultation paper from the Financial Stability Board. However, despite this hope, policy in the European Union and most other nations remains premised on taxpayer support (a principle reaffirmed in the most recent EU crisis).

As discussed above, much systemic regulation – e.g., the surcharge for global systemically-important banks – is based on the view that firms backed by likely bail-out should pay up front for this privilege. However, where there is no bail-out, there is no privilege to pay for. Thus, SIFIs that want to limit the scope of systemic regulation should (as most do) support a rigorous resolution regime that puts all on notice that, under stress, a SIFI is little different from any other large firm subject to the indignities of the Bankruptcy Code or whatever other insolvency regime applies. The only exception for SIFIs, as crafted in the Dodd-Frank Act, needs to be limited protections so that the government steps in to ensure orderly resolution, insulating markets from panic firesales of assets or from sudden freezes in inter-financial liquidity that create crises where none need have been.

Key bricks in a robust orderly-resolution regime that prevent panic and bar bail-out include:

- **Clear, Limited Deposit Insurance**: One reason why the U.S. financial crisis was less of a catastrophe than it might have been, or even more of a macroeconomic mess than it was, is the presence of the FDIC's sticker on the door of every insured depository. After one failure (IndyMac) in which the FDIC's rusty knowledge of how to close a large bank briefly posed systemic risk, the agency went back to business and shuttered every insured depository through receivership, conservatorship or mandatory sale. But, in the course of the crisis, Congress hiked deposit insurance to $250,000 per account, restructured assessments to charge for assets (decoupling deposit insurance from its purpose), allowed deposit brokering to continue and suggested that even unlimited coverage could remain after the banking system is stabilized. If FDIC coverage gives depositors a no-risk proposition, then banks of all sizes will take full advantage of the government's backstop. Effective resolution for all SIFIs starts with regulated institutions within them and a disciplined regime for insured depositories is at the heart of this priority reform. Failing this, funds will flow from holding companies subject to bankruptcy to insured banks, exacerbating risk to taxpayers and the prospect of big bail-outs.

- **Living Wills**: As noted, large U.S. banks have now been ordered to draft resolution plans that show how they can be broken apart and shuttered under the Bankruptcy Code. This is a costly exercise, not to mention a complex one. It's also a waste of time if bailout remains possible and banks are double-taxed for it by these costly plans, as well as all the other SIFI rules. Regulators should thus proceed with the living-will requirements, stiffening them where necessary by ensuring that SIFIs can also recover under unanticipated operational stress. Standards judging ready resolution and recovery should be stringent and regulators should be allowed to order substantial restructuring if firms fall short. But, this is a substitute for all the rules premised on TBTF "negative externalities," not a requirement to be added atop them.

This policy could be called resolve-and-release – that is, SIFIs should be subject to a no-bailout resolution regime, demonstrate they can be handled under it and, then, be regulated only for the prudential risks they pose, not also for an implicit taxpayer guarantee. The challenge to this disciplined approach is skepticism that nations will have such regimes and that SIFIs in fact can be handled under them. This is not unreasonable, given recent history, but it's also unfair both to regulators and SIFIs. In essence, this skepticism forces regulators to mandate so many rules that adherence to any of them is at best uncertain, making complexity risk a parallel hazard to whatever systemic risk remains after all the rules are promulgated.

Regulation without regard for ready recovery-and-resolution capacity also puts any firm designated as a SIFI that, even though it can be readily resolved due to all the costly protocols put in place, is still treated as it could enjoy a bail-out and is burdened by the huge body of regulation aimed at curbing this now non-existent negative externality. However, shadow firms subject neither to these rules nor the resolution protocols will enjoy a converse framework: few rules and no costly resolution plans permit far more cost-effective and/or profitable operation, as well as continued offering of speculative products barred for banks and other regulated SIFIs. This will, of course, exacerbate systemic risk, especially given the uncertain state of the macroprudential rules meant somehow to avert it.