Cycle Proof Regulation

In their communiqué at the conclusion of their recent meeting, the leaders of the G-20 vowed to “strengthen financial regulation to rebuild trust”. Their collective willingness to sign on to more regulation should, however, give them pause. For we typically regulate in the midst of a bust when righteous politicians feel the need to do something, when bankers’ frail balance sheets and vivid memories makes them eschew any risk, and when regulators have backbones stiffened by public disapproval of past laxity. But we reform under the delusion that the regulated, and the markets they operate in, are static and passive, and that the regulatory environment will not vary with the cycle. Ironically, faith in draconian regulation is strongest at the bottom of the cycle, when there is little need for participants to be regulated. By contrast, the misconception that markets will take care of themselves is most widespread at the top of the cycle, at the point of maximum danger to the system. We need to acknowledge these differences and enact cycle-proof regulation, for a regulation set against the cycle will not stand.

Consider the dangers of ignoring this point. Recent reports have argued for “countercyclical” capital requirements -- raising bank capital requirements significantly in good times, while allowing them to fall somewhat in bad times. While sensible prima-facie, these proposals may be far less effective than intended.

To see why, recognize that in boom times, the market demands very low levels of capital from financial intermediaries, in part because euphoria makes losses seem remote. So when regulated financial intermediaries are forced to hold more costly capital than the market requires, they have an incentive to shift activity to unregulated intermediaries, as did banks in setting up SIVs and conduits during the current crisis. Even if regulators are strengthened to detect and prevent this shift in activity, banks can subvert capital requirements by taking on risk the regulators do not see, or do not penalize adequately with capital requirements.

Attempts to reduce capital requirements in busts are equally fraught. The risk-averse market wants banks to hold a lot more capital than regulators require, and its will naturally prevails.

Even the requirements themselves may not be immune to the cycle. Once memories of the current crisis fade, and once the ideological cycle turns, there will be enormous political pressure to soften capital requirements or their enforcement.

To have a better chance of creating stability through the cycle -- of being cycle-proof -- new regulations should be comprehensive, contingent, and cost-effective. Regulations that apply comprehensively to all levered financial institutions are less likely to encourage the drift of activities from heavily regulated to lightly regulated institutions over the boom, a source of instability since the damaging consequences of such drift come back to hit the heavily regulated institutions in the bust, through channels that no one foresees. Regulations should also be contingent so they have maximum force when the private sector is most likely to do itself harm.
but bind less the rest of the time. This will make regulations more cost-effective, which will make them less prone to arbitrage or dilution.

Consider some examples of such regulations. First, instead of asking institutions to raise permanent capital, ask them to arrange for capital to be infused when the institution or the system is in trouble. Because these “contingent capital” arrangements will be contracted in good times when the chances of a downturn seem remote, they will be relatively cheap (compared to raising new capital in the midst of a recession) and thus easier to enforce. Also, because the infusion is seen as an unlikely possibility, firms cannot go out and increase their risks, using the future capital as backing. Finally, because the infusions come in bad times when capital is really needed, they protect the system and the taxpayer in the right contingencies.

One version of contingent capital is for banks to issue debt which would automatically convert to equity when two conditions are met; first, the system is in crisis, either based on an assessment by regulators or based on objective indicators, and second, the bank’s capital ratio falls below a certain value. The first condition ensures that banks that do badly because of their own idiosyncratic errors, and not when the system is in trouble, don’t get to avoid the disciplinary effects of debt. The second condition rewards well-capitalized banks by allowing them to avoid the forced conversion (the number of shares the debt converts to will be set at a level so as dilute the value of old equity substantially), while also giving banks that anticipate losses an incentive to raise new equity well in time. Of course, learning from the recent experience of foreign investors who put in money just before US banks declared more losses, new equity investors will need to be convinced that banks have disclosed fully all potential losses they know about.

Another version of contingent capital is to require that systemically important levered financial institutions buy fully collateralized insurance policies (from unlevered institutions, foreigners, or the government) that will infuse capital into these institutions when the system is in trouble. Yet other versions would require banks to arrange for capital to top-up losses based on public signals.

Consider next regulations aimed at “too-big-to-fail” institutions. Regulations to limit their size and activities will become very onerous when growth is high, thus increasing the incentive to dilute them. Perhaps, instead, a more cyclically sustainable regulation would be to make these

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1 See [http://www.cfr.org/publication/19002](http://www.cfr.org/publication/19002)


3 See [http://experts.foreignpolicy.com/posts/2009/03/30/to_regulate_finance_try_the_market](http://experts.foreignpolicy.com/posts/2009/03/30/to_regulate_finance_try_the_market)
institutions easier to close. What if systemically important financial institutions were required to develop a plan that would enable them to be resolved over a weekend?

Such a “shelf bankruptcy” plan would require banks to track, and document, their exposures much more carefully and in a timely manner, probably through much better use of technology. The plan will need to be stress tested by regulators periodically and supported by enabling legislation – such as one facilitating an orderly transfer of the institution’s swap books to pre-committed partners. Not only will the need to develop a plan give these institutions the incentive to reduce unnecessary complexity and improve management, it will not be much more onerous in the boom, and may indeed force management to think the unthinkable at such times.

A crisis offers us a rare window of opportunity to implement reforms. The temptation will be to over-regulate, as we have done in the past, only to liberalize excessively over time. It would be better to think of cycle proof regulation.

Response to Comments

First, let me thank the Economist for hosting this debate and the many commentators who offered very useful thoughts on the ideas in my piece. Second, I would like to thank colleagues in the Squam Lake group (two of whom, Martin Baily and Hyun Shin, added their comments), with whom I have had enlightening exchanges on regulation. Finally, I should give credit to Mark Flannery of the University of Florida for first proposing the notion of contingent capital.

A short magazine page does not allow one to do full justice to the complexities of a problem. So if commentators rightly complain about my oversimplification of the issues, part of the blame lies with the space limitations in a magazine. But let me get to the comments. These fall into broadly three categories. Most commentators agree with the overall problem of pro-cyclical behavior. Many express some concern about specific elements of the proposals. Finally, a few add their own suggestions.

On the overall diagnosis, the disagreements seem largely a matter of emphasis. These come from people who are either more skeptical of any regulation (Peter Wallison and some posts from the Economist) or from those who think the problem was deregulation driven by ideology (David Min). I agree that skepticism is the right initial stance, but given that we cannot promise not to bail out large firms in the future, and have indeed created substantial precedents for doing so, we have no option but to think of appropriate regulation. To do otherwise would be destructive of the free enterprise system that Mr. Wallison cherishes, for it would entrench the power of large incumbent banks. While I sympathize with those who object to crude rules, I think Hyun Shin says it best when he argues that regulators rarely have the political or intellectual independence to exercise discretion, and “rules have a chance of success only when put in place at the outset, liberating the regulator to implement the consequences that flow from the rules”.

David Min rightly points out that the ideological cycle, which works on a longer time frame than the usual business cycle, had a major role to play, but I would argue that the greatest danger is when the ideological cycle, reinforced by past deregulatory successes, merges with the business cycle. Indeed, overregulation in the bust plays into the hands of the ideologues, for the first attempts at eliminating senseless regulations, once the recovery takes hold, adds so much economic value that it further empowers the deregulatory camp. Eventually, though, the deregulatory momentum causes us to eliminate regulatory muscle rather than fat.

Turning to my specific proposals, start with contingent capital. Peter Wallison worries that it is an idea that “sounds good on first hearing but immediately collapses when subject to even limited analysis”. He makes some good points but a moment’s reflection would suggest responses (which are contained in the more detailed analyses produced by the authors of the proposals) to his concerns. First, no one is proposing that levered financial institutions hold contingent capital claims on one another. That, as he and Annette Nazareth suggest, would be a disaster. It would, however, be simple to prohibit levered financial institutions (such as banks and insurance companies) from holding this class of claims, and easy to enforce such a prohibition. Who then would hold them? Typically unlevered institutions like mutual funds, pension funds, and sovereign wealth funds who like the added premium these kinds of instruments offer.

Would they hold these assets? We will not know until we try the proposals out. Yes, it would be painful for a mutual fund or a pension fund to suffer the loss. But not only would they have obtained a substantial premium earlier on for taking the risk but also, because they are unlevered, they will have the capacity to absorb the loss. More generally, these institutions hold equity, which is much riskier than the contingent capital proposed, both in normal times and in abnormal times. Equity has the advantage of being very liquid today, but if a sufficient amount of contingent capital is issued, it will become liquid also. Indeed, there is an instrument which works very much like our various forms of contingent capital – it is known as a credit default swap on bank debt! It pays a lot when banks are in deep trouble. I do not see great reluctance to either price that swap or to take the side of the insurer. Indeed, one form of contingent capital is precisely for a bank to buy credit default swaps on a portfolio of banks.

Of course, if Wall Street protests too much against contingent capital, regulators can offer them the choice of issuing equivalent amounts of equity instead. I have little doubt which way financial firms will move, once their options are limited.

Some commentators object to the capital insurance proposal, arguing that insurers are likely to go broke precisely when banks are in trouble. The key therefore is for the insurance to be fully collateralized and hence fail-safe. Here is one way it could operate. Megabank would issue capital insurance bonds, say to sovereign wealth funds. It would invest the proceeds in Treasury bonds, which would then be placed in a custodial account in State Street Bank. Every quarter, Megabank would pay a pre-agreed insurance premium (contracted at the time the capital
insurance bond is issued) which, together with the interest accumulated on the Treasury bonds held in the custodial account, would be paid to the sovereign fund. If the aggregate losses of the banking system exceed a certain pre-specified amount, Megabank would start getting a payout from the custodial account to bolster its capital. The sovereign wealth fund will now face losses on the principal it has invested, but on average, it will have been compensated by the insurance premium.

Turn finally to the closure proposal. Peter Wallison objects on grounds that the FDIC will not have the money to make good on the losses to depositors. I disagree. First, if the banks can be closed then they ought to be closed through prompt regulatory action way before the bank’s equity cushion, let alone its uninsured debt cushion, is fully eaten through. Second, a cursory study of past crises suggests that, typically, the longer regulators wait to close insolvent banks, the larger the eventual losses are to taxpayers. So I see quick closure as a benefit rather than a weakness.

Mr Thoma and a commentator from the Economist ask whether we will be able to ensure that such closure plans are serious. This is why regulators will have to stress test them periodically. Even if not perfect, the fact that banks have to produce the plans will force both banks and regulators to think about current weaknesses in legislation and regulation that prevent prompt closure, thus creating an impetus to remedy them. My sense is that if we set ourselves a goal to achieve weekend closure, automation, legislation, and organizational changes can get us a significant part of the way in a few years.

Martin Baily asks if we will impose too much of a tax on complexity with a closure plan. Perhaps! But I would rather we imposed a tax on (hopefully unnecessary) complexity than a tax on growth or variety. Alternatives like proposals to limit the size of financial institutions or to bring back Glass-Steagall-like separations would impose a far greater tax, and would be relatively ineffective to boot (see later).

Charles Goodhart raises the important point of cross-border operations. I am afraid that one outcome from this crisis may be that national authorities will insist that foreign banks conduct local operations through a separately incorporated local subsidiary. While this will impede efficiency, it could enhance stability, and make closure easier. More generally, any bankruptcy plan will have to address knotty issues such as who has closure authority, what the loss-sharing arrangements between countries for closed banks will be, and how foreign operations of domestic banks will be treated. This is something that regulators have to pay far more attention to.

Finally, let me turn to alternatives. I was, by no means suggesting that only these two regulations were needed, and that they could substitute for the whole host of regulations that are being contemplated. In particular, I am very sympathetic to the notion that compensation should be geared towards long term performance, with bonuses paid out over time rather than
immediately. I am also intrigued by Mr. Ludwig's plea for greater reserving. Reserves are akin to the bank holding more capital except that because reserves reduce profits and thus book capital, the capital does not really show up on the books so the bank cannot run it down by taking more risk. Similarly, the Geneva Report’s proposal of marking to funding deserves closer examination. I am not against countercyclical capital requirements but I do not think they will be as effective as their fans suggest.

I find less compelling some of the more drastic regulatory measures that have been proposed. For instance, some have suggested that banks with insured deposits should not engage in trading for their own account, an activity known as proprietary trading. This would be a modern version of the 1933 Glass Steagall Act that separated commercial and investment banking in the United States. In addition to making the system more stable by pushing volatility-inducing activities away from areas that cannot be allowed to sustain losses, it might be argued that the separation is enforceable -- because the lines are so clearly drawn, the public will know when they are being erased. Moreover, once in place, such separation will create pockets of rents that will generate defenders of the separation; the specialized proprietary traders will fight tooth and nail to prevent the commercial banks from encroaching on their turf. Finally, separation can create a variety of different players and strategies rather than a monolithic herd. This will lend stability to the system.

Yet these virtues may be more illusory than real. Glass-Steagall worked for a while only because there really was not much value to combining activities in the immediate post-Depression years. Over time, and long before the official repeal in 1999, it had been eroded in myriad ways. Not only are bright lines never so bright – for instance, how do you tell “illegitimate” proprietary trading from “legitimate” hedging – but also by standing in the way of private value creation, they generate enormous incentives to go around them. I would prefer uniform regulation to regulation that creates islands of regulation surrounded by uncharted oceans of the unregulated.