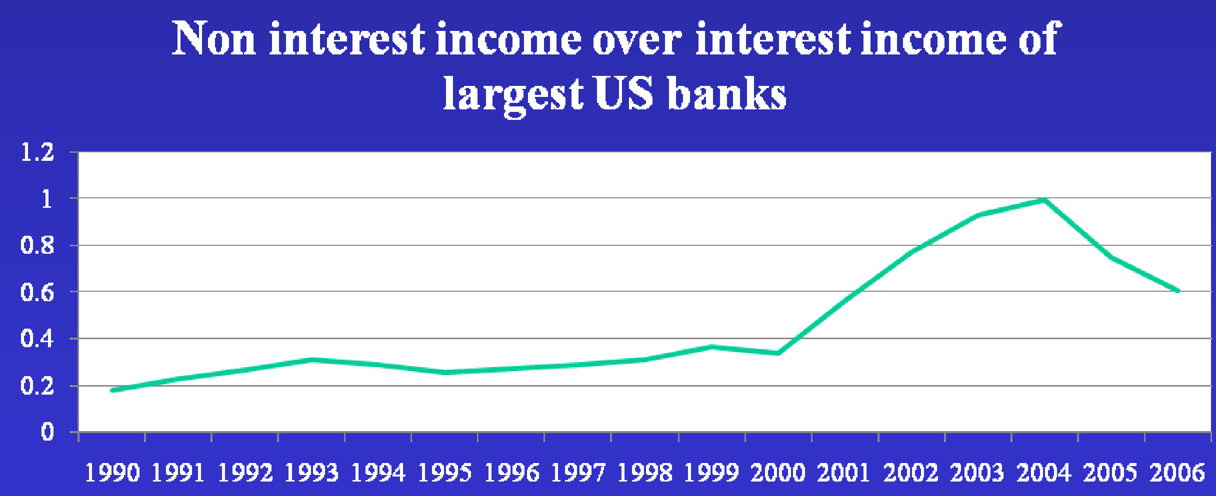
Subprime crisis: What will change in financial regulation and supervision?

João A.C. Santos
Federal Reserve Bank of New York

1. The seven sins of bank regulation and supervision

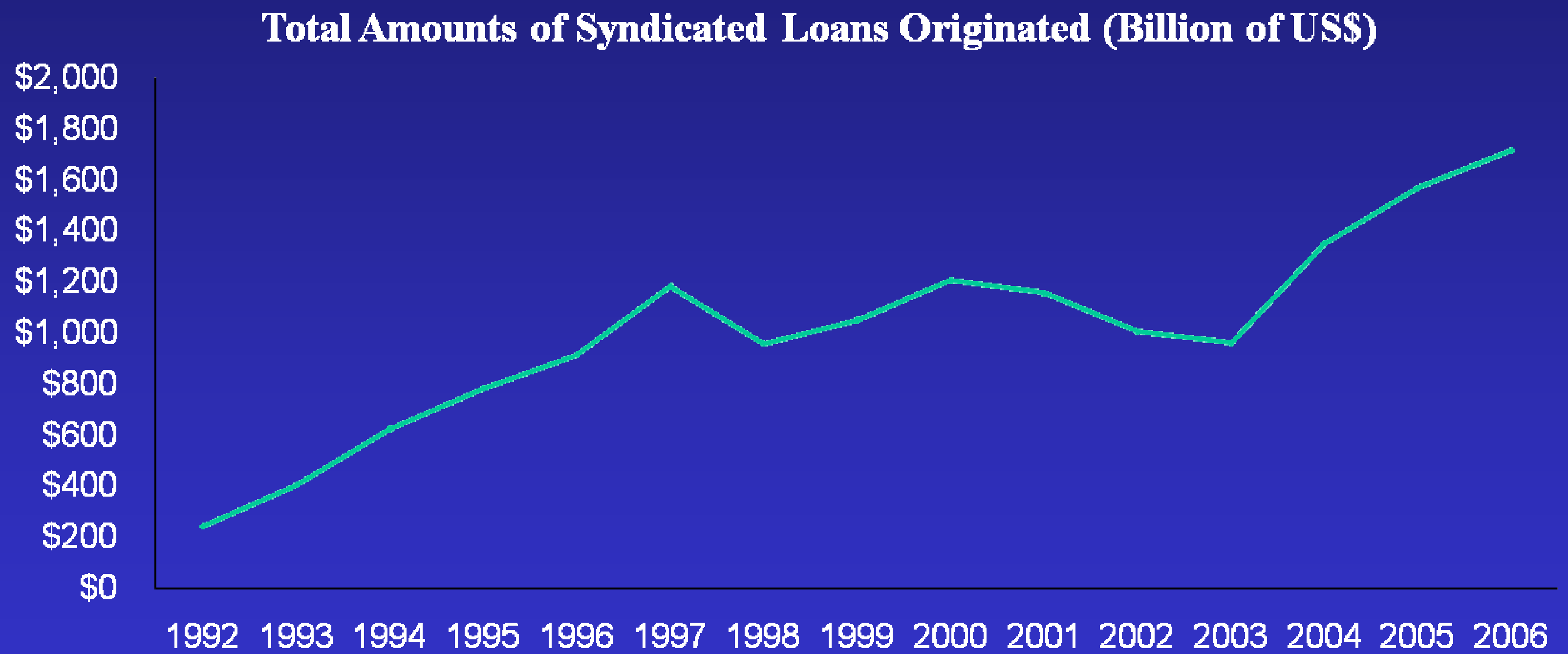
Sin 1: Did not follow the transformation of banking (a)

- Traditional banking:
  - Deposits were their main source of funding
  - Banks originated securities which they held until maturity
  - Non lending business was not significant
- Modern banking
  - Growth of nondeposit funding
  - Growth of non-lending business



Sin 1: Did not follow the transformation of banking (b)

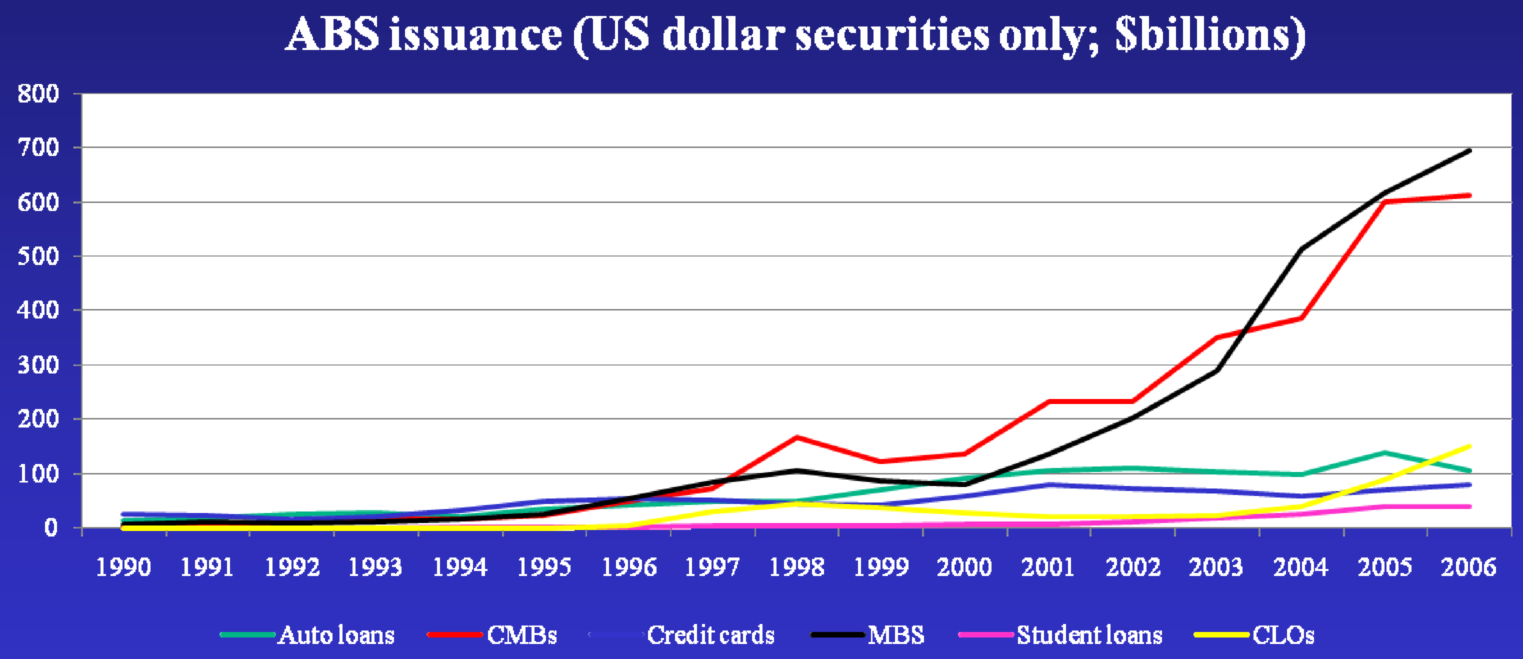
– Originate to distribute (the asset or the exposure)
  - (1) The syndicated loan market grew continuously



  - (2) So did the secondary market for loans: From a mere $8 billion in 1991, the trading volume of loans reached $176 billion by 2005.

Sin 1: Did not follow the transformation of banking (c)

- (3) As well as securitization



- (4) And the market for CDSs: From a total notional amount of $600 billion in 1999, this market grew to $17 trillion by 2006.

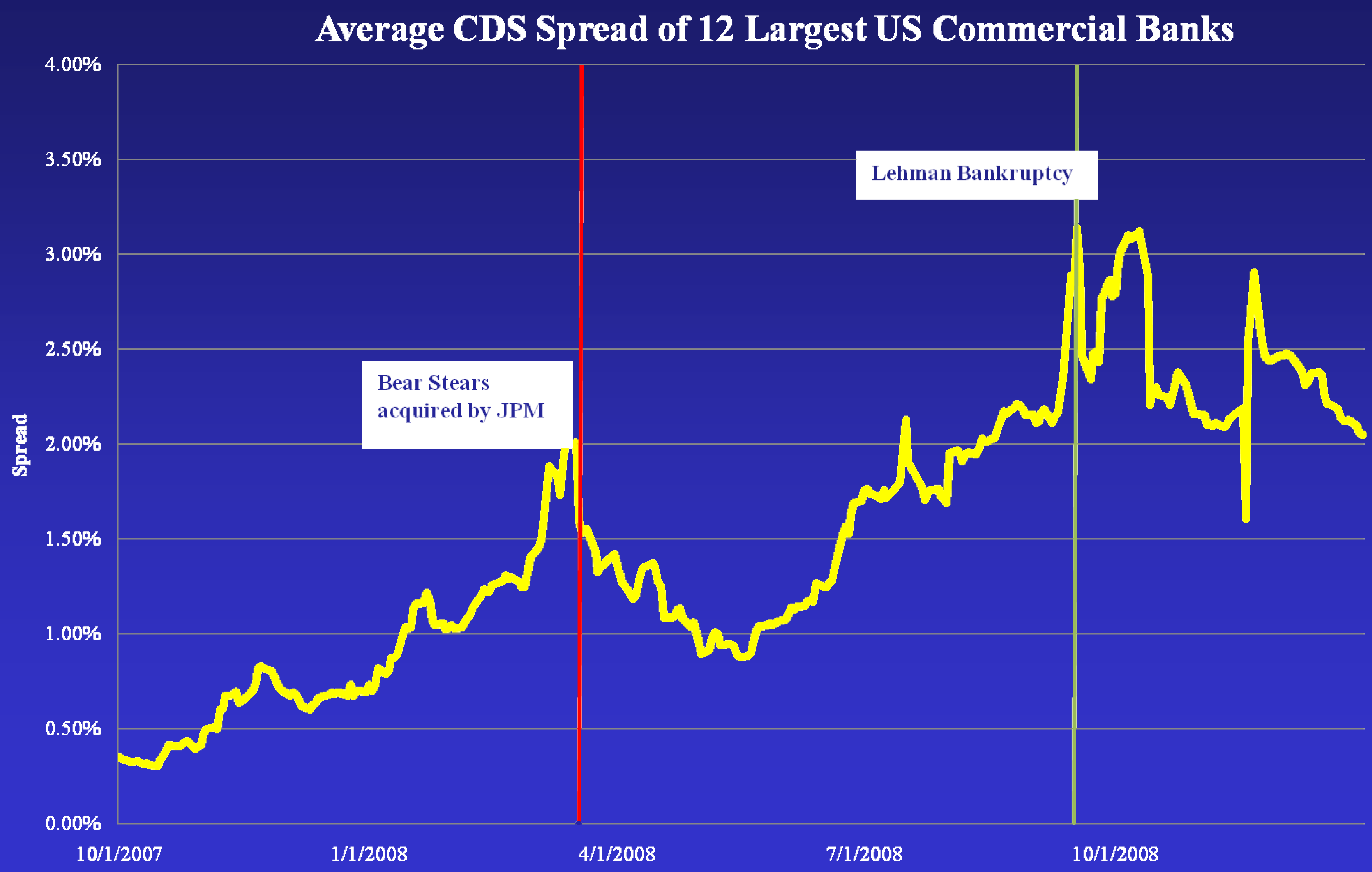
Sin 1: Did not follow the transformation of banking (d)

- This transformation had profound implications in the risk profile of banks
  - Banks' new funding sources made them more exposed to financial markets
  - The originate to distribute model made it easier for banks to originate new risks and to pass them on to other parts of the financial sector, but banks did not become "immune" to these risks.

Sin 2: Did not account for nonbank intermediation (a)

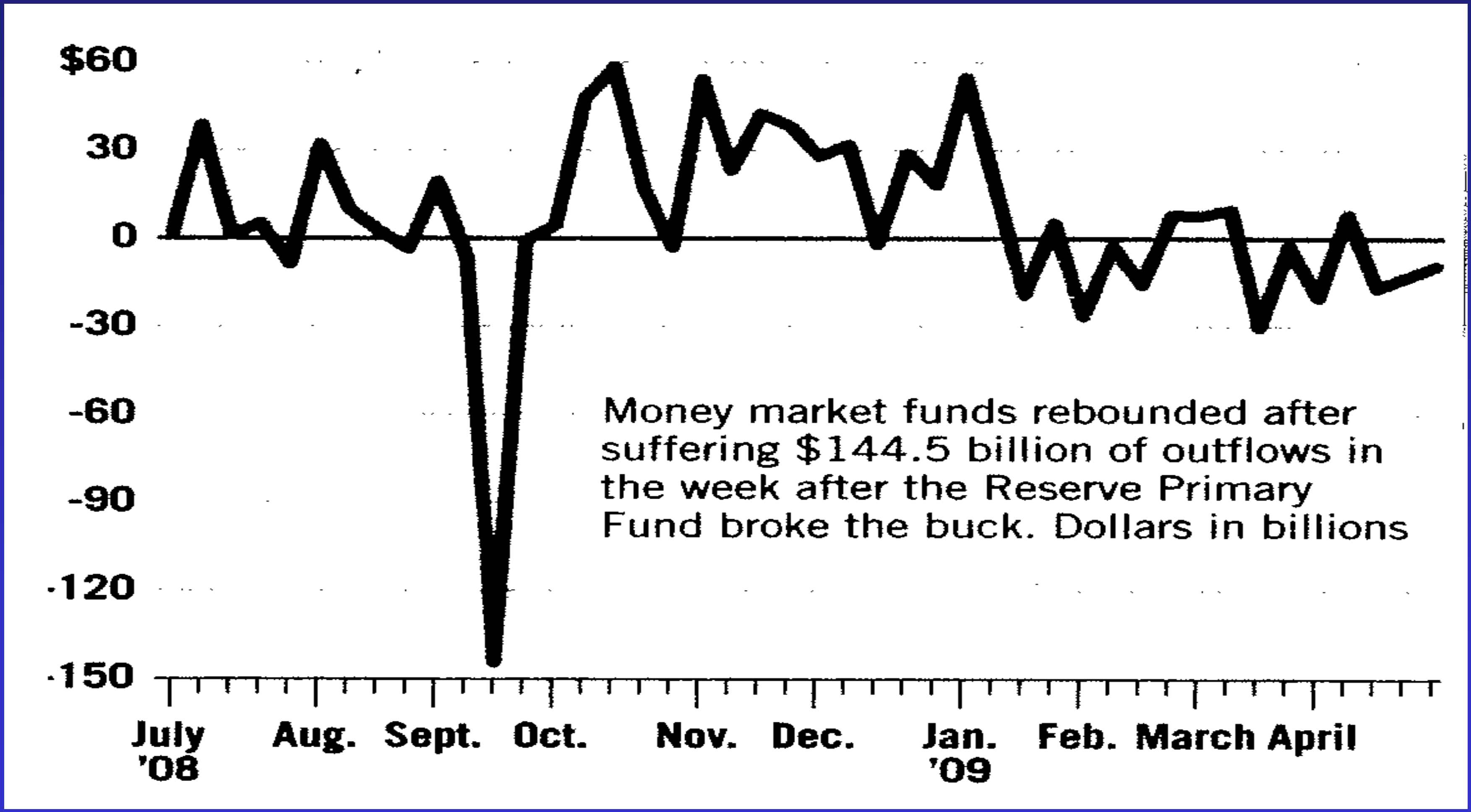
Top Issuers of US Denominated ABS/MBS, 1985-2008				
Rank	**Consumer/Auto Loans ABS**	**Credit Card ABS**	**MBS**	**CMBS**
1	Ford Credit	Citi	Countrywide	JP Morgan
2	GM Acceptance Corp	B of America	Lehman	Wachovia Bank
3	Chrysler Financial	Chase Bank	GM Acceptance Corp	Lehman
4	Daimler Benz	Capital One Bank	Morgan Stanley	Credit Suisse
5	Americredit	Discover Card	Credit Suisse	Morgan Stanley
6	Nissan Auto	American Express	Goldman Sachs	B of America
7	Honda Auto	JP Morgan	Merrill Lynch	Bear Stearns
8	WestCorp	First USA	Bear Stearns	Goldman Sachs
9	Capital One Bank	Bank One	First Franklin	Citi
10	Chase Bank		Washington Mutual	Merrill Lynch

Sin 2: Did not account for nonbank intermediation(b)

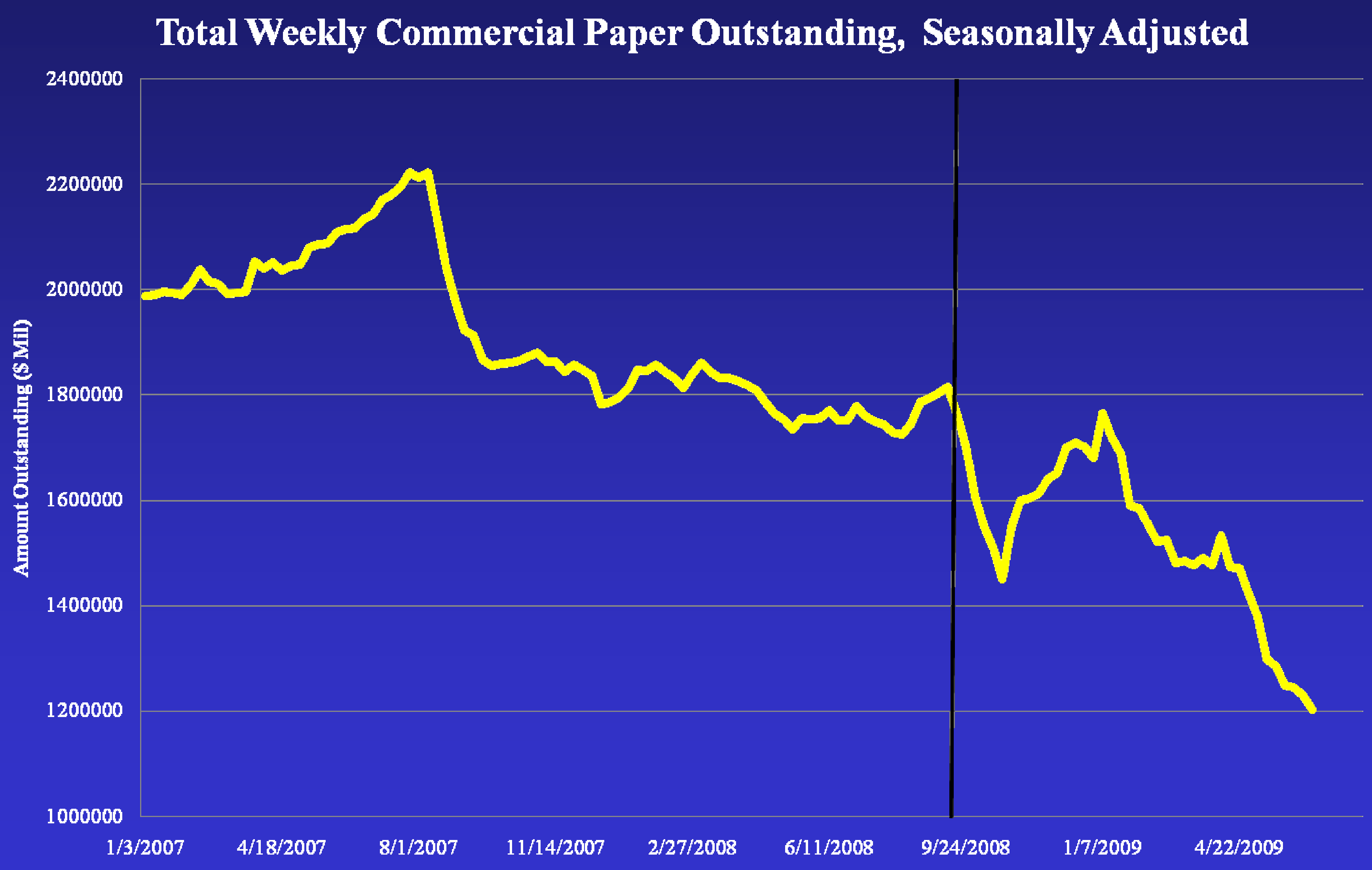


Sin 2: Did not account for nonbank intermediation (b)

- Withdrawals from money market funds after Reserve Primary Fund broke the buck in Sept of 2008



Sin 2: Did not account for nonbank intermediation (e)



Sin 2: Did not account for nonbank intermediation (f)

Source: Federal Reserve Board (Billions of dollars)

Sin 2: Did not account for nonbank intermediation (g)

- As a result, the stability of the banking system became dependent on the stability of the shadow banking system
- In addition, maintaining the stability of the banking system stopped being sufficient for maintaining the stability of the financial system

Sin 3: Did not follow the growth in the complexity and sophistication of banks

- In the era of traditional banking, there was a level playing field between regulators/supervisors and banks
- As banks became more sophisticated and complex, this made it difficult for regulators/supervisors to keep up with them
- This made it difficult to supervise banks effectively
- It affected regulators/supervisors' leverage, making it harder to enforce regulations
- It also made it easier for regulatory/intellectual capture

Sin 4: Did not fully account for systemic risk

- Concerns with deposit runs and with problems in the interbank market led to the introduction of deposit insurance schemes and lender of last resort arrangements.
- But, systemic risk may arise from other sources.
- Systemic risk is not a key driver of capital standards, deposit insurance premia or of prompt correction schemes.
- Systemic risk does not appear to be a key driver of supervisory practices, either.
- Yet, systemic risk is the most common argument put forth for regulating and supervising banks.

Sin 5: Failed to take into account banks' incentives

- Banks' objectives do not mimic the objectives of regulators
- For example, they will not internalize the potential negative externalities that arise from their failure
- Thus, banks' choices, including those of the so called well run and managed banks, cannot be used as a benchmark to set regulatory standards

Sin 6: Failed to account for the implications of market imperfections and frictions

- Financial markets are not "complete."
- They are also subject to imperfections and frictions.

- As a result, they may not be able to regulate themselves.
- Once they deviate from equilibrium, they may not return to equilibrium at least within an "acceptable" period of time.

Sin 7: Failed to account for regulators' incentives

- The regulatory infrastructure in most countries often assumes that regulators' incentives to gather information are independent of their use for this information
- It also assumes that different agencies have perfect incentives to share private information with their counterparts
- In addition, it assumes that all agencies have their incentives perfectly aligned and that they all act for the "common good"

- Agency problems, and differences in the mandates of regulatory agencies often invalidate these assumptions.

2. Treasury proposal to modernize the oversight of financial markets

Summary of the Treasury proposal (a)

A) Regulation and supervision

1. Create a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, and advise the Fed.
2. Give the Fed authority for consolidated supervision and regulation of Tier I FHCs.
3. Supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries. Prudential standards for Tier 1 FHCs – including capital, liquidity and risk management standards – should be stricter than those of other financial firms.
4. Combine OCC with the Office of Thrift Supervision
5. Create a resolution regime for BHCs, including Tier 1 FHCs.

Summary of the Treasury proposal (b)

- **<u>A) Regulation and supervision (cont.)</u>**

6. Amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of the Treasury
7. Recommend the Basel Committee to:
   - modify Basel II by refining the risk weights applicable to the trading book and securitized products,
   - introduce a leverage ratio, and improve the definition of capital,
   - review Basel II to mitigate its procyclical effects.,
   - expedite the work to improve cross-border resolution of global financial firms.
   - take steps to improve liquidity risk management standards for financial firms.

Summary of the Treasury proposal (c)

B) Hedge funds

Recommend that hedge funds (and other private pools of capital) register with the SEC, and report information that is sufficient to assess whether any fund poses a threat to financial stability.

C) Money Market Mutual Funds

Recommend that the SEC to strengthen the regulatory framework to reduce the credit and liquidity risk of MMFs and make the MMF industry less susceptible to runs.

D) Insurance

Create the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.

Summary of the Treasury proposal (d)

E) Securitization

Propose that Federal agencies promulgate regulations requiring originators or sponsors to retain a stake in their products. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.

F) Rating agencies

The SEC should continue to strengthen the regulation of credit rating agencies, including measures to disclose conflicts of interest, and differentiate between structured and other products. Recommend that regulators reduce their use of credit ratings in regulations and supervisory practices.

Summary of the Treasury proposal (e)

G Markets

Recommend that all OTC derivatives markets, including CDS markets, be subject to comprehensive regulation that addresses relevant public policy objectives.

H) Payment and settlement systems

Propose that the Fed has the responsibility and authority to conduct oversight of systemically important payment, clearing and settlement systems. Also propose these systems have access to the Fed discount window.

Summary of the Treasury proposal (f)

I) Executive compensation

Recommend that federal regulators issue standards and guidelines to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions

J) Consumer protection

Create a federal consumer protection supervisor to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.