



Lombard Street

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The collapse of the world's financial markets has resulted in intense examination of how to restructure and reform regulation for banking, securities, insurance, and other parts of the financial services industry. Various regulatory proposals are already being circulated in academic and public policy circles. Governments around the world are considering reforms. The conversation and decisions surrounding these proposals will fundamentally impact how financial services is structured and conducted across the globe throughout the 21st century.

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About Lombard Street

Lombard Street is the first ever e-journal focused exclusively on financial services regulation. Titled after the famous treatise on banking regulation authored by Walter Bagehot in 1873, this biweekly journal is filled with original pieces from prominent thought leaders across the globe.

Overseen by a multi-disciplinary editorial board led by David S. Evans of the University of Chicago and University College London, Lombard Street delivers original articles that will shape and chronicle the evolution of the impending 21st century financial services regulation reform.

Lombard Street leverages the power of the Web to provide germane and timely thought leadership to a broad and relevant audience. The online format works to fuel interaction between readers and authors, extending the dialogue beyond just the articles.

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The Regulatory Thicket

David S. Evans¹

Who was minding the store during the period that led up to the breathtaking collapse of financial institutions and the freezing of financial markets? The answer in the United States is a dizzying array of state and federal regulators each of whom had their one piece of the financial system to look after. This article provides an overview of this regulatory thicket. Knowing where we have been is important for figuring out how the government should regulate financial services in the 21st century and reduce the likelihood of future catastrophic failures.

I. An Overview of the Financial Services Industry

The financial services industry provides a variety of products and services that, broadly speaking, have to do with money. It provides critical services in connecting—that is, acting as an intermediary between—different members of the economy: between borrowers and lenders, between investors and capitalists, and between payers and payees. It can be divided into three main types of businesses: banks, securities firms, and insurance companies.

Banks are generally in the business of lending money. A significant portion of banks are depository institutions. People and businesses deposit their money at an institution which provides them with check-writing services and some investment possibilities. Knowing that not everyone will need their deposits at the same time, the institution then lends a multiple of its deposits. The extent of that leverage is an important variable in bank stability. Depository institutions include retail and commercial banks, savings and loans, and credit unions. Retail banks focus on consumers and commercial banks on businesses, although many banks focus on both. Credit unions are owned in effect by the depositors. Savings and loans institutions lend primarily for home mortgages. A related institution is a mortgage bank which lends money for mortgages based on funds received from Fannie Mae, Freddie Mac, and other providers of mortgage funds. Banks are also in the business of making and receiving payments. People make deposits at banks in part so they can write checks and make electronic transfers and so they can put money they receive into their accounts. A number of other businesses are involved in this as well, including those involved in credit, debit and prepaid cards.

Security firms facilitate the buying and selling of stocks and bonds directly or indirectly. At the center of the stock market are exchanges, such as Nasdaq, which provide venues for offering and taking liquidity.

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Dealers such as market makers and specialist companies provide liquidity—that is, they offer to buy or sell equities at particular prices and make their money from the spreads. Brokers arrange trades for their clients that take that liquidity. The investment banks are broker-dealers that earn trading profit by offering liquidity as well as commissions for placing orders. Hedge funds and investment funds typically rely on brokers to take liquidity from exchanges. Similar types of firms buy and sell government and corporate bonds. These bonds tend to be far more unique than equity—they vary in terms of maturity and risk—and are often exchanged bilaterally rather than on organized exchanges.

People and businesses can pay insurance companies to take risk off their hands. Life insurance companies do this by selling annuities, pensions, and life insurance products—all of which are based on bets on how long people will live. Property and casualty companies insure all other kinds of risk ranging from automobile accidents to hurricanes to various financial products. Insurance companies make money by pooling risks and charging a premium for doing so. They also make money by investing these premiums. Hence insurance companies are significant players on the buy-side of financial markets. Insurance companies try to reduce their risks by themselves buying insurance. They do this by paying reinsurers to take on some of the risks they have acquired. The insurance industry is an important player in financial services because they account for a large portion of the money invested in stocks and bonds, and because they insure the complex financial products that have been one of the major sources of the financial calamity.

These businesses are intertwined in a variety of ways. Some of the large businesses play in all parts of the financial services industry. Citibank does retail and commercial banking, operates an investment bank, and until recently did insurance. AIG insured complex financial products including providing something known as a credit default swaps as well as investing massive amounts of insurance premiums in the financial markets.

II. Financial Services Regulation in the United States

I have not made an exhaustive effort to count all of the regulators in the United States. Roughly speaking, there are at least seven federal regulators and around 150 state regulators of the financial services industry.

A. Federal Regulation

There are five main regulators for banking, two for securities, and oddly none for insurance. For the banking sector these include:

1. The Federal Reserve Board (FRB) which regulates banks that belong to the Federal Reserve System;

2. The Office of the Comptroller of the Currency (OCC) of the U.S. Treasury which regulates all national banks;
3. The Office of Thrift Supervision (OTS) which regulates savings and loans;
4. The National Credit Union Administration (NCUA) which stays on top of credit unions;
5. The Federal Deposit Insurance Corporation (FDIC) which regulates and examines banks that are eligible for federal deposit insurance.

In addition, the Securities and Exchange Commission regulates the securities markets and the Commodities Future Trading Commission deals with futures contracts such as commodities futures and stock options.

A large financial institution such as Citi which also has an investment bank would be subject to regulations by all of these with the exception of the OTS and NCUA. The list above isn't necessarily exhaustive. For example, the Federal Trade Commission's Bureau of Consumer Protection weighs in on a variety of banking and credit card disclosure issues.

B. State Regulation

Every state has regulators too. They have bank regulators for state-chartered banks. They typically have an insurance commission that regulates the activities of all insurance companies in the states regardless of where the company is domiciled. And they usually have laws and often regulations that deal with securities. These may be administered by the State Attorney General or by a separate state agency.

These state agencies have associations that to some extent coordinate their activities. The National Association of Insurance Commissioners is the most important of these because it partly fills in the vacuum left by the lack of any federal authority. Others include the Conference of State Bank Supervisors and the National Association of Credit Union Supervisors.

III. The Thicket

Thus a lot regulatory authorities oversee the financial services industry. From the standpoint of the regulated companies that means that at least the large ones must deal with multiple regulators. The insurance industry is the extreme. Large insurance companies typically deal with insurance regulators in all 50 states, each of which controls aspects of what the company can do in those states. Large national banks will typically not have to deal with state regulators but they will have to deal with the five major federal bank regulators and possibly the securities regulators as well.

From the standpoint of the regulators, that means that they typically only see a piece of the financial services industry. No regulator sees more than the state operations of insurance companies. Several of the national banking regulators only cover a portion of the banks or only a portion of their activities. Then there are portions of the financial services industry that are largely not subjected to regulation. That includes hedge funds and private equity firms.

The United States has a far more decentralized and uncoordinated regulatory process than any other country. The Table shows the situation in several major countries. The United Kingdom, for example, has a single regulator called the Financial Services Authority that oversees banking, insurance, and securities. The European Community overall, however, also has a decentralized and largely uncoordinated system. The economy of the European Community is about the same size as the United States. It is partly integrated with many member states having adopted the euro and there ostensibly being free trade and free flow of labor. Each EC member state has one or more regulatory authorities for financial services. There is no material coordination of these authorities across the EC.

Table: Financial Regulatory Authorities in Selected Countries

Country	Banking	Securities	Insurance
United Kingdom	FSA	FSA, FRC (for accounting and auditing)	FSA
Japan	JFSA (+BOJ)	JFSA (+SESC)	JFSA
Germany	BaFin (+Buba+LZBs)	BaFin	BaFin
Italy	Banca d'Italia	CONSOB	ISVAP
Canada	OFSI+CDIC	Provisional Securities Commission	OSFI
France	Commission Bancaire (Banque de France)	AMF	CCA

Source: Adapted from Davies & Green, *Global Financial Regulation: The Essential Guide*, p. 156.

The complexity of financial services regulation presents a challenge. It is safe to say that the financial services industry in the United States has not suffered from a lack of regulatory oversight as measured by the sheer number of regulatory authorities and personnel overseeing it. Whether we had the right regulations and whether the personnel at these agencies exercised their enforcement powers diligently is another matter.

We do not know for a fact that the complexity and lack of coordination among regulatory authorities was the source of the crisis or whether a more centralized approach in the United States would have averted or mitigated the disaster. A data point, however, is that the United Kingdom's single FSA seems to have fared no better.

The complexity of the system in the United States does make reform difficult though. We will need to layer yet more regulatory structures on top of an already seemingly unwieldy system. Or, we will need to simplify and therefore ultimately disable many of the separate regulatory authorities. Supplanting the state oversight of the insurance industry with a federal regulator is just one example of the restructuring that will need to be considered.

Financial Services Regulation: Working Towards an Agenda for Reform

Stephen R. Malphrus²

The financial turmoil that began last summer has impeded the ability of the financial system to perform its normal functions and has adversely affected the broader economy. Regulatory authorities have been actively considering the implications of the turmoil for regulatory policy and for private-sector practices. Last year, the President's Working Group on Financial Markets ("PWG") issued a report on their findings on the causes of recent market turmoil and recommended changes in the financial markets³. At the international level, the Financial Stability Forum has also issued a report and recommendations. Specific problem areas that have been identified in a number of reports over the last year include: mortgage lending practices and oversight; risk measurement and management by large financial institutions; capital, liquidity and leverage ratios; the performance of credit rating agencies; accounting and valuation issues; and issues relating to the clearing and settlement of financial transactions. Many of the recommendations in these reports are directed at regulators and the private sector and are already being addressed. These reports complement the Blueprint for Regulatory Reform issued by the Treasury Department last year, which focused on broader questions of regulatory structure.

Work is also ongoing to strengthen the framework for prudential oversight of financial institutions. Notably, events over the past year have led the Basel Committee on Banking Supervision to consider increasing capital charges for such items as complex-structured credit products, assets on banks' trading books, and liquidity guarantees provided to off-balance-sheet vehicles. Various reports have stressed the need for supervisors to insist on strong risk-measurement and risk-management practices that enable risk managers to assess the risks faced on a firm-wide basis.

The potential vulnerability of the financial system to the collapse of Bear Stearns was exacerbated by weaknesses in the infrastructure of the financial system, notably in the markets for over-the-counter ("OTC") derivatives as well as in short-term funding markets. Much work is underway to address infrastructure issues as well.

² Stephen Malphrus is the Staff Director for Management, Board of Governors of the Federal Reserve System. These comments represent my thoughts on regulatory reform and are not intended to represent the evolving position of the Board of Governors. My comments regarding the Government Accountability Office (GAO) report on regulatory reform are taken directly from the report and my work with the GAO.

³ Memorandum for the President, March 13, 2008 from Secretary Paulson: President's Working Group on Financial Markets Policy Statement.

The financial turmoil is ongoing, and our efforts today are concentrated on helping the financial system return to more-normal functioning. It is not too soon, however, to think about steps that might be taken to reduce the incidence and severity of future crises. Indeed, much is being written about regulatory restructuring, and I will spend the remainder of this report on this topic as recently addressed by the Government Accountability Office.

In January 2009, the Government Accountability Office (“GAO”) published a report to Congress titled *Financial Regulation: A framework for crafting and assessing proposals to modernize the outdated U.S. Financial Regulatory System*. The GAO performed extensive research including discussions with federal and state supervisory authorities including self-regulatory organizations, associations representing the financial sector, and academic and industry experts. For example, the GAO asked me to assemble the federal and state regulators as well as key self-recruiting organizations to provide the GAO team with our thoughts and feedback on their draft framework. A similar request was made to the American Bankers Association for the financial sector associations to provide the GAO with their views and thoughts on regulatory restructuring. The GAO report does not recommend a new regulatory structure but offers Congress a framework to evaluate restructuring proposals such as the Treasury blueprint.

GAO identified five changes in the financial system highlighting limitations and gaps in the current regulatory system:

- First, regulators have struggled to mitigate the systemic risks posed by large and interconnected financial conglomerates to ensure that risks are adequately managed. The portion of firms operating as conglomerates crossing the financial sectors of banking, securities, and insurance has increased significantly in recent years, but none of the regulators are currently tasked with assessing the risks posed across the entire financial system.
- Second, regulators have had to address problems in financial markets resulting from the activities of less-regulated market participants—such as nonbank mortgage lenders, hedge funds, and credit rating agencies—some of which play significant roles in today’s financial markets.
- Third, the increasing prevalence of new and more complex investment products has challenged regulators and investors. In addition, consumers have faced difficulties understanding new and increasingly complex retail mortgage and credit products.
- Fourth, standard setters for accounting and financial regulators have faced growing challenges in ensuring that accounting and audit standards appropriately respond to financial market

developments, and in addressing issues arising from the global convergence of accounting and auditing standards.

- Finally, despite the increasingly global aspects of financial markets, the current fragmented U.S. regulatory structure has complicated some efforts to coordinate internationally with other regulators.

As I mentioned, GAO's goal was to develop a framework that Congress could use to evaluate and, if necessary, craft regulatory reform proposals. The framework consists of nine characteristics that they believe should be reflected in a restructured regulatory system. The characteristics include:

1. **Clearly defined regulatory goals:** Goals should be clearly articulated and relevant, so that regulators can effectively carry out their missions and be held accountable. Key issues include considering the benefits of re-examining the goals of financial regulation to gain needed consensus and making explicit a set of updated, comprehensive, and cohesive goals that reflect today's financial environment.
2. **Appropriately comprehensive:** Financial regulations should cover all activities that pose risks or are otherwise important to meet regulatory goals. These regulations should also ensure that appropriate determinations are made regarding how extensive such regulations should be, considering that some activities may require less regulation than others. Key issues include identifying risk-based criteria, such as a product's or institution's potential to create systemic problems for determining the appropriate level of oversight for financial activities and institutions, and closing gaps that have contributed to the current crisis.
3. **Systemwide focus:** Mechanisms should be included for identifying, monitoring, and managing risks to the financial system regardless of the source of the risk. Key issues include: Determining how to effectively monitor market developments to identify potential risks; The degree, if any, to which regulatory intervention might be required; and Who should hold such responsibilities.
4. **Flexible and adaptable:** A regulatory system that is flexible and forward looking allows regulators to readily adapt to market innovations and changes. Key issues include identifying and acting on emerging risks in a timely way without hindering innovation.
5. **Efficient and effective:** Efficient and effective oversight should be developed, including eliminating overlapping federal regulatory missions where appropriate, and minimizing regulatory burden without sacrificing effective oversight. Key issues include determining opportunities for consolidation

given the number of overlapping regulators, identifying the appropriate role of states and self-regulation, and ensuring a smooth transition to any new system.

6. **Consistent consumer and investor protection:** Consumer and investor protection should be included as part of the regulatory mission to ensure that market participants receive consistently useful information, as well as legal protections for similar financial products and services—including disclosures, sales practice standards, and suitability requirements. Key issues include determining what amount, if any, of consolidation of responsibility may be necessary to streamline consumer protection activities across the financial services industry.
7. **Regulators provided with independence, prominence, authority, and accountability:** Regulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions, and be clearly accountable for meeting regulatory goals.
8. **Consistent financial oversight:** Similar institutions, products, risks, and services should be subject to consistent regulation, oversight, and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally. Key issues include identifying activities that pose similar risks, and streamlining regulatory activities to achieve consistency.
9. **Finally, taxpayer exposure:** A regulatory system should foster financial markets that are resilient enough to absorb failures and thereby limit the need for federal intervention and limit taxpayers' exposure to financial risk. Key issues include identifying safeguards to prevent systemic crises and minimizing moral hazards.

What Will It Take to Stabilize the Banks?

Martin Neil Baily and Douglas J. Elliott⁴

There is considerable disagreement about how to handle the current severe financial crisis that has contributed mightily to the deep recession in which we find ourselves. Before we lay out our suggestions, it is important to underline a few ugly truths:

- **No one knows the right answers with certainty.** Although there are historical parallels for many aspects of the crisis, the combination is unprecedented. Answers that worked in the Depression, the Savings and Loan crisis, or Sweden in the 1990's provide useful input, but there are dramatic differences between our situation now and each of those past crises.
- **Every available solution is bad and the best we can do is to find the least ugly answer.** A lot of culprits, both people and impersonal forces, dug this deep hole. We will have to pay a very high price to climb out again, a price we have already begun to pay.
- **The pain is not even close to being over.** How bad it gets depends on the economy's path, as well as the solutions applied. Banks have not fully recognized the existing losses on their books and we know that the deepening recession will produce substantially more losses. Those additional losses will require still further aid from the taxpayers and will reduce the value of some of the investments taxpayers have already made.

I. Background: How Bad Are The Underlying Losses Likely To Be?

Determining the right solution depends in large part on assessing how bad the credit losses will become. This in turn depends on a view of the depth of the recession. Table 1 compares the expectations for credit losses for U.S. banks and broker dealers in three careful analyses, all from January 2009. The lowest estimate is from the International Monetary Fund ("IMF") using their revised forecast. Goldman Sachs has published estimates modestly higher than the IMF's. Finally, Professor Nouriel Roubini of the Stern School of Business at New York University, has published the most pessimistic major forecast. The table goes on to show the actual and potential sources of replacement capital and the net effect on system-wide capitalization.

⁴ Baily is a Senior Fellow and Elliott a Fellow at Brookings. Baily was Chairman of the Council of Economic Advisers under President Bill Clinton. Elliott was the founder of COFFI, a think tank on federal financial institutions, and a financial institutions investment banker with JP Morgan.

Table 1: Projected losses on U.S. credit risk and effects on total banking capital (\$ billions)

	IMF	Goldman	Roubini	Average
Estimated global losses on U.S. credit	(2,200)	(2,000)	(3,600)	(2,600)
Loss estimates for US banks and broker/dealers	(900)	(1,000)	(1,800)	(1,233)
New capital raised already ¹	510	510	510	510
Reduction of capital needs by US guarantees ²	20	20	20	20
Portion of TARP 2 assumed to be infused ³	200	200	200	200
Core bank earnings 2008-2010 ⁴	500	500	500	500
Cash dividends paid, 2008-2010 ⁵	(90)	(90)	(90)	(90)
Tax benefits on losses ⁶	50	50	50	50
Total change in capital	290	190	(610)	(43)

1. Average of estimates from Goldman Sachs and Roubini
2. Guaranteed amount * 80% reduction in risk-weighted assets * 6% "well-capitalized" tier 1 capital ratio
3. Author's estimate for allocation of second \$350 billion tranche
4. Author's estimate based on historic earnings plus credit charges at FDIC-insured banks
5. Author's estimate based on historic dividends at FDIC-insured banks, reduced for 2009 and 2010
6. Author's estimate based on historic income taxes at FDIC-insured banks

Each forecast starts with a projection of losses from U.S. credit instruments (both whole loans and syndicated/securitized products). These loss estimates are substantially higher than those for "toxic assets" alone because many of the credit losses stem from more standard conservative loan types, such as commercial and industrial loans. For example, Roubini's analysis projects that under 40 percent of the credit losses would come from securitized products, the category under which virtually all toxic assets fit. Many of the credit losses will not hit U.S. banks because the risks were transferred to foreigners or non-bank buyers through securitization or loan syndication, so line 2 on the table is roughly half of line 1. Line 2 is shown in bold because this is our starting point, the projected aggregate effect of credit losses on the U.S. banking system.

These large losses will be offset substantially by several sources of new capital. First, there was approximately \$510 billion of capital raised by U.S. banks and broker dealers through 2008, much of it public money. Second, the government reduced the needed capital for Citigroup and Bank of America by agreeing to guarantee all but about 20 percent of the potential losses from specified large pools of their assets. This guarantee was reflected in a lowering of the capital required to back these assets, producing the same net effect as adding an equivalent amount of capital while keeping the capital requirement flat. Third, it appears that approximately \$200 billion of the second installment of the TARP program would be available for capital infusions.

Finally, the banks will accumulate substantial core earnings during this recession, prior to the effect of credit losses. We have already factored in the full effect of projected credit losses and should therefore not double count by using net income that also reflects those credit losses. Not surprisingly, banking is very profitable even in recessions, if one ignores the effect of credit losses. One might object that the capital

from these core earnings will not be available up-front, but the projected losses will also manifest over time and therefore will not diminish capital entirely on day one. This is true even without regulatory forbearance—some losses in this recession will not become evident until 2010 or even later.

In sum, the banking system can be restored to the capital levels that held prior to this recession, which were considered more than adequate at the time, if the economy and credit losses perform as the IMF or Goldman Sachs expects. These forecasts are roughly in line with the consensus economic view.

Professor Roubini, however, has a considerably more pessimistic forecast for the harm from this recession. For example, he is currently forecasting a 5 percent total drop in gross domestic production from peak to trough, while the consensus forecast is in the 3 percent range. (For those who follow economic numbers less closely, please note that the much-reported decline in the most recent quarter was, as always, given on an annualized basis, making it appear four times larger. The actual drop thus far in the recession is around 1.5 percent.) In addition, he estimates that housing prices will drop another 20 percent, at or above most predictions.

This grim forecast drives his estimates for credit losses, which are much higher than estimates from the IMF and Goldman. It is worth emphasizing this point. Roubini's methodologies for projecting credit losses appear to be generally in line with those of the IMF. His figures are so much larger primarily because his view of the economy is grimmer. If he is correct, there will be a much larger capital hole to fill than is available from currently foreseen sources, which increases the pressure for nationalization or other drastic action.

So far, this discussion has focused solely on the adequacy of capital for the entire U.S. banking system. Clearly, a major capital deficit for the banking system as a whole would necessarily imply that a number of individual banks were undercapitalized. However, system-wide capital problems are not necessary for individual banks to be in trouble; the distribution of capital across banks is also important. The system could be adequately capitalized, yet individual major banks could be substantially undercapitalized but extra capital at other banks would offset the system as a whole.

II. The Way Forward: What Should Be Done?

Restoring the financial system to permanent good health requires the right action on three fronts:

- **Recapitalizing the Banks:** Capital is the cushion that protects shareholders, depositors, and customers from the effects of banks' mistakes and misfortunes. There have been so many of each that virtually all banks need more capital to restore the necessary cushion. This will be available

over time from the private sector, but the taxpayer is the only realistic source for now of the “bridge” capital that will carry us through until private markets are restored.

- **Cleaning up the “toxic assets:”** The banking system owns large quantities of highly complex securities whose values are tied in complicated ways to the value of underlying mortgages. These securities have lost a great deal of value as house prices have plummeted. Even worse, it is very difficult at this point to know the true value of these securities, making it hard to know how safe the banks are.
- **Halting the recession:** The financial crisis affects the economy, but is also affected by it, as shown above. The stimulus package and the efforts to slow the decline in house prices, particularly through attempts to mitigate the problem of foreclosures, need to work in order to put a floor on the value of the loans and investments that banks hold. This topic is larger than we can deal with in this short paper, but it must be borne in mind when evaluating actions that focus more directly on the banks.

A. Recapitalizing the Banks

We largely agree with the steps to recapitalize the banks which were announced as part of the Administration’s Financial Stability Plan as well as the subsequent announcements concerning “stress tests” for the 19 largest banks⁵. We do not see the need to nationalize banks on any broad basis at this point. It is better to wait to see whether the economy deteriorates so drastically that such a change in plan becomes a necessary last resort⁶. There are two key points relating to recapitalization in the Financial Stability Plan.

(1) Continued significant use of direct capital injections, but on tougher terms and more selectively focused on weaker banks. Instead of buying ordinary preferred stock, the government’s shares would be converted into common stock automatically at the end of seven years if the government judged that the bank needed the capital. New injections of capital would be focused on banks weak enough to need the capital, but strong enough to be able to increase lending after receiving the new capital. (The strength of the banks would be measured in part against a new “stress test,” looking at a bank’s ability to withstand a

⁵ For more details, please see Douglas J. Elliot: “Bank Capital and the Stress Tests” (March 3, 2009); “Bank Nationalization: What is it? Should We Do it?” (February 25, 2009); “Designing the Public/Private Partnership Part I: What Role for the Taxpayer?” (February 20, 2009); “The Administration’s New Financial Rescue Plan” (February 10, 2009); Brookings Initiative on Business and Public Policy. Also see Robert E. Litan and Martin N. Baily, “Fixing Finance: A Roadmap for Reform.” Fixing Finance Series: Brookings Initiative on Business and Public Policy (February 2009). These articles and others are available at our website: www.brookings.edu/projects/business.aspx

⁶ Please see Elliot: “Bank Nationalization: What is it? Should We Do it?”

significant worsening in the economic environment.) This approach contrasts with the previous one of injecting additional capital into all but the weakest banks in order to restore confidence in the wider banking system.

The Administration did a good job of balancing between pressures to “nationalize” the banks and a desire not to scare away private investment. Bankers are extremely unpopular right now and there is a strong push to extract a pound of flesh in exchange for any future capital infusions. Many have argued that the government ought to buy common stock in the weak banks, rather than preferred shares, thus capturing more of the upside and receiving at least the potential for significant voting control. However, existing shareholders are extremely concerned about handing over large stakes in their banks at what they judge to be “fire sale” stock prices. Fears of exactly this kind of dilution of value have hit the stocks of Citigroup, Bank of America, and other banks that are judged to be potential recipients of such a government investment.

If the government took a significant share of the common stock of some of the most troubled banks, the most vulnerable of the remaining banks would likely see their share prices decline sharply. This has two bad effects. First, many other constituents—such as lenders, trading counterparties, and rating agencies—take the share price as a leading indicator of changes in creditworthiness. As we saw in September and October, sharp declines in share prices can lead to a kind of run on the bank by these creditors and trading counterparties. Unfortunately, such runs tend to be contagious, weakening confidence in the entire financial system. Second, if investors are worried about the prospect of nationalization should the economy have another setback, it will take longer and be harder to entice new private investment into banks when the system starts to stabilize.

In this context, the Administration’s plan to use convertible preferred stock is appealing, because this stock type causes less dilution to current shareholders, especially as the preferred stock can be bought out prior to conversion if the bank becomes stronger.

(2) Measuring the adequacy of capital at the largest banks through a “stress test.” Regulators are in the process of subjecting the 19 largest banks (those with more than \$100 billion of assets) to a test to determine what effect a very severe recession would have on the adequacy of their capital⁷. The results of the test will determine how much additional capital the regulators will push the banks to raise over the following six months. The government will backstop this capital-raising by agreeing to buy mandatorily-convertible preferred stock in the form described earlier, up to the full extent of the capital need.

⁷ See Elliot, “Bank Capital and the Stress Tests” for more details.

In this key component of the Financial Stability Plan, the Administration is right on virtually all counts. It is right to insist on comprehensive, uniform stress tests to measure the effect on banks of a considerably more severe recession than expected. But it would not be helpful, as some have suggested, to move to a test of still more extreme conditions. That kind of test would create unreasonable pressure to take actions, such as sweeping nationalizations, that are quite unlikely to be necessary.

It is right to insist that the banks temporarily carry additional capital sufficient to handle this stress case, since a large audience needs reassurance that the banking system can handle the worst case scenario. It is right to focus primarily on raising this cushion through additional Tier 1 capital, which includes a fairly wide range of capital instruments. The government should focus on protecting depositors, customers, and trading counterparties of the banks, all of whom would benefit fully from the protection of Tier 1 capital.

At the same time, as is rumored to be part of the plan, it would also be right to insist that enough of this capital be in the form of common stock, the purest form of capital, in order to reassure the stock market. This crisis has demonstrated how a sharp fall in a bank's stock price can spook many constituencies of the bank, creating wider problems. However, this should not mean requiring an excessively high proportion of common stock in the capital structure. Beyond a certain point, federal purchases of common stock reduce the value for existing stockholders while simultaneously transferring too much risk to taxpayers.

B. Cleaning Up the Toxic Assets

The Administration will need to make some critical decisions soon on its plan to create a public/private partnership to buy "toxic assets" from banks⁸. The plan was announced by Treasury Secretary Geithner on February 10th in terms of broad principles, with the mechanisms to be designed over the following few weeks. The idea is to move as many of the toxic assets as possible off the books of the banks, where they have been wreaking havoc by creating massive uncertainty as to the solvency of those banks. The Administration has concluded that there needs to be substantial involvement from private investors who are, collectively, the party best able and most motivated to evaluate these complex assets. At the same time, the government needs to be involved in order to provide incentives to break the logjam that has held trading volumes in these securities to extremely low levels.

The most fundamental question about the public/private partnership is the proper financial role of the taxpayer. In order to make the partnership work, the government probably must provide cheap financing for the private investors, combined with guarantees of the assets' floor values and with a minimal emphasis on government co-investing by directly purchasing toxic assets.

⁸ Please see Elliot: "Designing the Public/Private Partnership Part I: What Role for the Taxpayer?" for more details.

The Administration faces strong practical pressures to encourage private investors to buy toxic assets by offering financing and guarantees, rather than attempting to execute a large program of direct government purchases of these assets. There are three main difficulties with direct asset purchases:

- Treasury has at most \$100 to \$200 billion to commit to the toxic asset program without going back for new legislation, given other commitments. The Administration is understandably reluctant to ask for politically unpopular new legislation. It might not pass or, if it is passed, might be festooned with provisions that would undermine the goal of restoring the financial sector. Either way, it would use up considerable time and political capital.
- Such purchases would lack the multiplier effect that guarantees would have in bringing in private investment. Hedge funds and other investment funds would not value the government as a co-investor, soaking up a portion of the limited supply of attractively-priced assets. On the other hand, they would place considerable value on guarantees and on cheap financing, both of which are scarce resources in today's market.
- It would also be difficult to multiply the size of the program by using money from the Federal Reserve, the only other body with the legal authority to commit to a program this large. The Fed has almost unlimited legal authority to provide loans or guarantees to private parties under "exigent" circumstances. However, it has a very strong preference to provide loans or guarantees only if they are backed by fairly low-risk assets. (Among other things, it presumably worries about becoming a massive hedge fund for the government, investing in politically favored high-risk ventures.) Partial guarantees from Treasury, combined with retention of some risk by private investors, can create low-risk assets out of otherwise high-risk assets, meeting the Fed's criteria.

Issuing guarantees would allow for a larger program for a given level of authorized spending by Treasury. Treasury could provide private investors with guarantees that would cover declines in the value of the toxic assets below a floor value, with the guarantee stopping at a still lower valuation level that was considered unlikely to be pierced. The Fed could then provide guarantees from that level down to zero.

The Fed would provide its portion of the guarantee by offering "non-recourse" loans, that is to say, loans which are secured by collateral, where the lender has no recourse back to the borrower if the borrower stops paying. A non-recourse loan effectively contains a guarantee that, if the value of the collateral falls below the amount borrowed, the Fed and the Treasury would be stuck with the shortfall. Some protection for the Fed would be provided by over-collateralizing the loan, securing it with assets initially worth more than the amount borrowed.

There is considerable precedent for this combined Treasury/Fed approach. It will be used for the new Term Asset-backed securities Lending Facility (TALF) program and has been used to provide guarantees and non-recourse loans to Bank of America and Citibank in the recent past.

An example may be helpful here. A public/private partnership could be constructed that would allow for purchases of \$1 trillion of toxic assets by private investors, such as hedge funds. In order to encourage this, Treasury would agree to provide, for a fee, a guarantee that the value of the investments would not fall by more than 20 percent, with the guarantee stopping at a 40 percent loss. This would result in a maximum potential loss by Treasury of \$200 billion, if the whole program were put in place and all the assets suffered a decline in value of 40 percent or more. (Private investors would have absorbed an equally large loss.) The Fed would agree to lend the investors up to 80 percent of the value of the assets on a non-recourse basis, secured by the full amount of the assets. The loans would be priced to take account of the partial protection from the Treasury guarantee. The Fed would carry the risk that asset values fell by more than 40 percent, an unlikely enough event that it should still be able to provide quite advantageous interest rates.

Recent leaks have suggested that there may be multiple investment funds, each of which might largely fund itself through debt with a government guarantee. This would be a second way of providing cheap funding and federal guarantees against losses beyond a certain point. Either way, the taxpayers' economic exposure would be essentially the same.

III. Conclusion

The Treasury and the Federal Reserve should move aggressively to stabilize the banking system and restore confidence; indeed, there is no higher economic priority at this time. The steps that need to be taken are pretty clear; indeed, they have been clear for awhile. There must be an adequate amount of capital injected into the banks and the troubled assets must be moved out of the banks or their impact neutralized. Both of these actions will be very expensive for the taxpayers, involving significant risk of large future losses. The amount of money needed is not known as yet because we do not know how bad the recession will be which influences the volume of assets that will default as people stop paying on their mortgages or credit cards, and businesses declare bankruptcy. We do not share all aspects of Nouriel Roubini's dire view of the economy, nor do we agree with his call for nationalizing the banks, but his forecast of a 5 percent decline of the economy from peak to trough is quite possible, indeed the drop may be even larger than that. So the costs of stabilizing the banks will be very large indeed. The sooner policymakers face up to that, the better.

Reform of the Regulatory System

R. King Milling⁹

As I reflect upon the regulatory system, or lack thereof, which has partly contributed to today's economic challenges, I have reexamined my view of the mission of banks in this complex world. Not surprisingly, it hasn't changed.

A bank's mission is to make loans that can be repaid, gather low cost deposits, maintain liquidity, acquire sound investments, establish appropriate reserves, and preserve adequate capital. This mission may seem rather mundane when described this way, but, if done right, shareholders will prosper over the long haul. The bank will survive and prosper as well. It is when these fundamentals are compromised by greed, ignorance, technological complexity, manipulation, and/or unintended consequences from ill-conceived regulations and legislation that banks and banking systems begin to stress. This is where we find ourselves today.

Whitney, with approximately \$12.5 billion, is 125 years old, well capitalized, and is predominantly a commercial enterprise. Domiciled in New Orleans, its footprint stretches from Houston to Tampa. While it has experienced the bottomless valuation phenomena prevalent in the state of Florida, and is experiencing the repercussions of a distressed economy, it is important to take note that the Whitney did not participate in the creation or accumulation of subprime, exotics, or no-documented instruments, and has avoided executing, purchasing, or retaining complex or synthetic derivatives. Nor has it invested in hedge funds or been a party to credit default swaps. I would speculate that, in regards to these factors, it matches the profile of in excess of 80 percent of all banks regulated by the OCC and the Fed (not 80 percent by size, of course, but rather by number). Today, all of us are the victims of a great paint brush which equates the actions of a few to the whole. Hopefully, we can and will avoid future repetition.

To that end I would suggest that as we infuse significant funding into our economy, we take the time to critically analyze the regulatory system and determine if it meets the challenges presented by this new world.

There seems to be little doubt that the root cause of our malaise is real estate—the abnormal increase in the number of mortgages and the proliferation of non-traditional underwriting standards. It is evident that a significant percentage of those lenders that prepared and executed these mortgages had little or no understanding of the fundamental principles of lending; or worse, they were driven by greed with full

⁹ Mr. Milling previously served as the President of Whitney Holding Corp. and its subsidiary, Whitney National Bank from 1984 to March 2007. He is retired from the Bank as of December 2008. This article is adopted from a speech he presented on February 19, 2009.

recognition that, because they had no skin in the game, they had little concern for the inherent train wreck that would ultimately overwhelm the system. These individuals and, in certain instances, unsupervised or under-supervised financial companies, violated the implicit principle that loans are underwritten with the expectation that the borrower can repay. Two and 28, three and 27, no docs, and similar loan terms clearly violate that principle.

Bringing this segment of the industry under the tent through regulation can begin the process of avoiding similar results in the future. At the same time, it is apparent that one or more regulating federal or state agencies utilized different standards of review for institutions under their domain, which allowed for the execution and proliferation of identically flawed mortgages. Uniformity of standards is essential.

A significant portion of these ill-conceived mortgages were sold upstream to investment houses and other institutions and ultimately bundled and securitized into what we now refer to as “toxic assets.” The method by which they were classified as something other than toxic—so as to facilitate their sale—was the imprimatur of approval rendered by one or more of our esteemed rating agencies. Without delving into the various reasons, these bundled instruments received ratings bearing little relationship to the quality of the securities themselves. Suffice it to say that by virtue of that seal of excellence, the holder was then able to sell the bundle to financial companies and others throughout the world. Regardless of whether the alleged seal of excellence was a byproduct of ignorance, conflicts of interest, or worse, the rating system has been called into question and it must be fixed. Accountability on the part of the acquirer to inspect what he is purchasing is also critical and should be required to the end that the purchasers assume some responsibility for at least trying to understand the quality of the acquired assets.

The third leg on this stool may present the ultimate conundrum. Complex derivatives, synthetic derivatives, hedge funds, and credit default swaps are difficult enough to understand individually but when we begin to think of them as trillions of dollars of on- and off-balance sheet obligations, is it not almost beyond our capability to assess risk? At the Whitney we chose not to deal in these instrument types as no one understood them. Some might suggest that this speaks to a lack of sophistication. Maybe so, but then you might want to question how many members of the boards of directors or, more succinctly, the management of WAMU, Countrywide, Merrill Lynch, Bank of America, Citibank, Lehman, Bear Stearns, AIG, and others had any idea of what was, or for that matter, is still in their portfolio and the risk associated with those portfolios? I suspect we all know the answer—not a clue. So when faced with such massive portfolios aided in large measure by complex technology, how can we be reasonably assure that we have gotten our hands around the problem? As you consider the possible solution you might also juxtapose the whole idea of “too big to fail.” Maybe a partial answer lies in posing the question, are they too big to regulate?

The accumulated impacts from these three issues ultimately accelerated the arrival of the long-anticipated recession. As the number of foreclosures increased and the value of the underlying assets of homes and commercial real estate decreased, other policies and regulations were also called into question. While there are others that might be the subject of a discourse, in this instance I speak particularly of the role of market value accounting and the inability of financial institutions to apply judgment in establishing reserves. These two policies fail as their application are counterintuitive and have contributed to the fundamental weaknesses.

Mark-to-market accounting was eliminated during the Great Depression as the very concept required institutions to reevaluate assets under conditions with no comparables. It resulted in irrational write-downs and diminished capital. Sound familiar? The SEC in the early 90s unilaterally reinstated the rule. The observations of the 1930s hold true today, when there is no connectivity between the ground condition relative to the valuation of assets, and the fundamental predicate forming the stated basis for mark-to-market, applying mark-to-market accounting is not just counterproductive, but damaging as well. If you question this, focus upon the happenings in Florida, California, and Nevada. The application of mark value accounting should be suspended.

Additionally, restricting banks from using rational judgment in establishing reserves is also counterintuitive. Today, established reserves are based primarily upon known losses, which results in banks diminishing their reserves in good times, prohibits adding reserves when economic clouds begin to appear, and results in having inadequate reserves upon the arrival of the downturn. As a result, rather than rationally establishing reserves in good times for the purpose of securing safety and soundness, banks generally exhibit unsustainable higher earnings which have little bearing upon the long-term strength and stability of the institution. When a severe economic downturn begins, the immediate reaction is to quickly supplement reserves at the same time as the bank's revenue stream is compromised— all of which results in the impairment of the most critical of assets, capital. Thus the fundamental requirement to maintain every element of safety and soundness becomes compromised at this most critical juncture. The SEC might feel comfortable with this result but I suggest no one else should. It requires total re-examination.

As in the past, we are witnessing the fragility of our financial system. Its maintenance depends upon regulations that support strength and stability and appreciate the nuances required not only to meet different risks in different geographic localities, but also the vagaries of changing economic conditions. Strict arbitrary rules which impede the ability to anticipate changing conditions cause uncertainty and impact credibility. Ultimately this situation can severely impact reputation which, under certain circumstances, foreshadows closure.

From Recession: An Opportunity to Stand up for Consumers

Susan C. Keating¹⁰

From its beginning in the housing market, the current economic crisis has spread gradually to infect every sector of our economy. The meltdown has defied the regulatory safeguards that were designed to limit the odds of widespread economic collapse and, in the process, raised serious questions about what went wrong and how to prevent it from happening again. Among the conclusions: America's financial regulatory system is overdue for repairs. And, the buzz in Washington is that we can convert this crisis into opportunity.

From my perspective as President and CEO of the National Foundation for Credit Counseling, among the opportunities is consumer credit—preparing consumers to use it effectively and protecting them from abuses by those who prey on individuals with credit problems. The experience of NFCC member agencies makes two things clear as we move through the recession—more people than ever before are turning to credit counselors for help and the severity of personal financial problems has grown significantly. And, while we cannot prove it empirically, the stories we hear from consumers convince us that improvements in regulation and a commitment to financial literacy should be part of our economic recovery agenda.

At the NFCC, we believe strongly that the consumer impact of the financial crisis has been worse than it needs to be because of three factors: inadequate disclosures about credit, a shortfall in regulatory oversight, and inadequate financial education. Evidence of all three failings can be found in the housing market collapse that began our current economic woes.

Part of the housing market problem was a failure of financial education because too many homebuyers didn't fully understand even the basics about their loans. Inadequate disclosure also played a role, because it is now clear that many lenders did not provide consumers with a full picture of their complex mortgage products, how they work, and the potential risks associated with them. The regulatory system fell short by failing to properly mitigate the risks of an overheated mortgage market. Far more time was devoted to designing creative new loan products than in assuring loan quality.

As we move forward, we should draw lessons from the mortgage market to insist on a few core principles and apply them widely—improving consumer disclosures, incentives, and mandates to expand consumer financial education and enhanced regulatory oversight.

¹⁰ Susan C. Keating is the President and Chief Executive Officer of the National Foundation for Credit Counseling (NFCC).

These fixes are partly the job of policymakers who can compel better disclosure and strengthen regulation to better protect consumers. Another part of the job involves what President Obama refers to as “taking responsibility”—the personal responsibility of every American to learn more about money management and the responsibility of both public and private sector leaders to make financial literacy a goal for every individual and family. Let me explain.

Disclosure means providing consumers with the information they need to understand risks and to responsibly manage financial products, services, and loans for which they’ve signed up. To be truly beneficial, disclosure also means that the terms must be spelled out in plain language so they are easy to understand.

For example, if you take out a mortgage you need to understand basic terms such as the dollar amount of the monthly payment and the interest rate. If the loan is adjustable, you need to know when the rate will adjust and how much your payment might increase—so you can match any possible increase against your budget. The failure to clearly inform consumers—in layman’s terms—how the products work is why some mortgages are now in default.

The disclosures also must be designed with real people in mind. Today, customers who apply for mortgages and credit cards are often overloaded with stacks of paper that take too much time to read and that only a lawyer can understand. The lengthy credit card agreement that comes with a new card and the privacy policies that load up our mailboxes illustrate that when it comes to disclosure, too much information can be almost as damaging as too little. What’s needed is a balance so that disclosures are clear to consumers who are not versed in legalese, but also provide the protection necessary for financial institutions.

Moving from pro forma disclosure to the beneficial disclosure we need will require financial service companies to invest time and dollars up front. But if we get it right, lenders should save money in the long run by cutting their loss rates and consumers will be better off by avoiding credit arrangements they can’t afford.

In addition to better disclosures, we need basic and fundamental financial education about how to budget and manage finances. Last spring, 25 percent of those polled in a NFCC Financial Literacy Survey said they didn’t know enough about the home-buying process to even consider buying a house. From sad experience, we now know that millions of Americans who did buy a home didn’t fully understand it either. That is why pre-purchase counseling and education is important for everyone, particularly first-time homebuyers.

In the same survey, we learned that only 40 percent of Americans set up a budget and keep close track of their spending. Indeed, 20 percent said they have no idea how they spend their money. Most Americans have never ordered their credit report; millions say they are regularly behind in paying their bills; most do not have a sufficient emergency fund set aside; and one-third report they have no retirement savings at all. Among the most worrisome finding is the high percentage of young Americans—more than 40 percent—who do not pay their bills on time. This suggests that financial habits are getting embedded earlier and may be getting worse instead of better. Numbers like this scream of a need for better financial education to enhance the value of improved disclosures. The benefit of even the best disclosure is greatly diminished when consumers don't know what to do with the information.

To this end, basic finance and money management should become a mandatory part of the standard school curricula in every state. Surveys show that financially literate consumers are more likely to make their loan payments on time and less likely to default. That should be a powerful incentive to everyone, especially creditors, to promote financial education. At a time when lenders are trying to reduce their risk, wouldn't it make sense if they promoted financial education by offering better credit terms to consumers who have completed such programs? Consumers, too, would certainly be better off and avoid a lot of pain if they took part in financial education before their finances deteriorated. If ever they would embrace the concept, it should be now—a “teachable moment” because recession has helped make clear the consequences of financial literacy.

Protecting consumers also requires additional regulation and integrated oversight. Regulators must adopt meaningful disclosure rules and quality and ethical standards for consumer financial products and services. They also must exercise tough oversight of the businesses that provide financial services. As we've learned, regulators will need to look beyond case-by-case reviews to also identify systemic patterns that may warrant further intervention. At the same time, tough regulation must not squeeze off all credit because the responsible use of credit is important to the economy. The challenge is to make the needed fixes, but without over-regulating or choking consumer access to appropriate credit and beneficial financial products. In other words, we must be thoughtful about unintended consequences as we work to beef up the regulatory regime.

Strong regulation has become more important as the recession deepens. Struggling with debts they can't repay, a growing number of Americans are looking for help. Many consumers are turning to nonprofit credit counseling agencies such as the member agencies of the NFCC. Nonprofit counselors are covered by very stringent consumer protection regulations that include rules for the types of services they offer, the fees charged, and even how agencies are funded. These rules, enacted by Congress just a few years ago with strong support from the NFCC, makes the nonprofit status a safe starting point for consumers who need help to stay afloat.

But other consumers, often lured by high-profile ads that promise quick fixes and easy solutions, are turning to an emerging group of “for-profit” services that, ironically, are less regulated than the nonprofit sector. Their track record is thin, and too often these businesses put their own bottom line ahead of the consumers.

At a recent FTC workshop on “debt-settlement” companies, even an executive for one such business conceded: “there are problems with the industry and fraudulent practices are more common than not.” So the agenda for better regulation must include new rules to protect consumers in their dealings with credit assistance organizations whose business model is based on profit. At a minimum, we must apply the same federal rules to the “for-profits” that apply to nonprofit credit counseling.

The ideas I’ve laid out are not a panacea. Recessions will still occur from time to time and some consumers will always struggle with money management and credit problems. But as we consider the lessons of recent experience, we have the ability to take measured steps that will strengthen regulatory oversight in the financial services arena and can empower consumers with the tools and education to better protect themselves. With better disclosure, financial education, and oversight, we can reduce the odds of consumer financial mistakes—no small feat at a time when foreclosures, bankruptcy, and loan defaults are at the top of the news. From the debacle of recession, we have an opportunity to do better. We should seize the moment.