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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 362

Edward J. Kane
(520)-299-5066

Franklin Edwards
(917)-921-4050

Statement of the Shadow Financial Regulatory Committee on

Deposit Insurance, Government Guarantees and Too-Big-To-Fail: What Remains To Be Done?

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Explicit deposit insurance and government guarantees are formal arrangements for backing up financial sector liabilities. Too-Big-To-Fail (TBTF) policies emerge informally, as contingent *ad-hoc* backup procedures that are expected to arise if and when the explicit backup systems intended to preserve the stability of the financial system fail or threaten to fail.

Post-crisis financial reforms typically strengthen formal backup regulatory systems. Recent reforms have expanded capital requirements, liquidity provisions, and stress tests for institutions and have instituted central clearing systems and mandated margin requirements for swaps. Data collection has been improved, insolvency-resolution powers broadened, and cross-border consultation strengthened in response to the breakdown of global systems during the Great Financial Crisis. But at the same time, regulators have consistently undercut the effectiveness of particular reforms to preserve their discretionary powers, and ways of testing the adequacy of the new backups by simulated “breakdown-and-recovery” experiments are still at an early stage.

"Schrödinger's Backup" is a time-tested maxim about backup systems in information technology. It holds that the condition of any backup is unknown until a "restore" is attempted. The Shadow Financial Regulatory Committee thinks that regulators need to face up to the implication of this maxim. Designing backups is easy, but achieving a viable restore is hard. For this reason, restores need to be tested regularly by the equivalent of war games. Untested recovery plans may seem adequate to the agency or interagency committees that designed them. But even the best plans are often undermined by wishful thinking, lobbying, or career pressures. Soliciting feedback from affected parties is part of the rulemaking process. In asking for modifications of any proposed rule, bank lobbyists usually focus not on its effects on the flow of safety-net subsidies, but on removing regulatory hurdles that might constrain lending, degrade customer service, or hamper banks' ability to compete with foreign or less-regulated institutions.

In past crises, Too-Big-to-Fail policies emerged as a way to restore the solvency of a collapsing financial system. The term provides a colorful way to describe policies of regulatory forbearance that in tough times dispense government subsidies to large, complex, or politically well-connected firms when they are in distress. Crisis accounts contained in the memoirs of Treasury, Federal Reserve, and FDIC officials in office during the 2007-2010 crisis events make it clear that their embrace of TBTF emerged due to the exigencies of the moment as an emergency "Plan B." Indeed, these memoirs can be viewed as conditioning their successors to find creative ways to bail out systemically important institutions in the next crisis if "necessary."

The Dodd-Frank Act of 2010 amended the emergency lending provisions of section 13(3) of the Federal Reserve Act. In the words of a Fed staff memorandum, the amendments authorize the Fed to extend emergency credit under that section "only for the purpose of providing liquidity to the financial markets through a program or facility with broad-based eligibility, and generally prohibit extending emergency credit for the purpose of assisting any single specific company avoid bankruptcy or resolution."

But the rule implementing these provisions approved by the Federal Reserve Board on November 30, 2015 redefines key words in ways that preserve much of the discretion that enabled the Fed to bail out individual TBTF firms and their creditors during the last crisis. The Board accomplished this by using its rulemaking authority to undercut the force of potentially restrictive terms in the language of this part of the statute.

The November 30th Fed rule interprets "broad-based" and resolvable "insolvent borrowers" loosely, and leaves the definition of terms that specify when and how distressed banks may be disciplined (such as "penalty rate" and "willful misrepresentation" regarding a borrower's hidden insolvency) to be determined at the moment. The rule defines a "broad-based" program as one that has at least <u>five</u> "eligible" participants and is not "designed" to assist any number of borrowing firms to avoid resolution. The Fed's definition of insolvency for purposes of the prohibition on lending to insolvent borrowers is backward-looking and rejects the well-established ideal of prompt corrective action. The "bright-line test" incorporated into the Fed's definition of an insolvent borrower introduces a previously non-existent grace

period by defining insolvency in terms of a "failure to pay undisputed debts as they become due during the 90 days prior to borrowing."

The Dodd-Frank Act and the rule that the Board finally adopted change the methods future Fed officials will have to use in bailing out TBTF firms. But if the new constraints had been in place during 2007-2010, they would not, in the Shadow Financial Regulatory Committee's view, have prevented the Fed from channeling to particular firms more or less the same amounts of credit support as it chose to dispense at that time. For example, under the Fed's new definition of an insolvent borrower, AIG would still have been eligible for bailout funds.

The unarticulated bottom line is that the Fed would not insist on retaining so much discretion if its leaders either believed or could demonstrate that post-crisis reforms have successfully established a robust standard that would end TBTF subsidies and allow TBTF firms to fail without placing the financial system or public funds at risk. Retaining so much regulatory discretion promotes risk-taking behavior in the TBTF universe. Instead of pretending that untested new backup arrangements can end TBTF subsidies, regulators could better enhance financial stability by setting up systems to measure, test, price, and respond to changes in the value of these subsidies as banks and shadow banks evolve through time.