Comments on “Will Financial Regulatory Reform Work? What Would?” by Charles Calomiris

Ellis Tallman

Oberlin College

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Summary

- A candid assessment of the reform process so far
  – **Bad news** – numerous reforms of questionable value
  – **Good news** – it is not too late to do things that might work
- The author's proposals are worth debating
  – My views are substantially in agreement
  – Challenges to the views aim to refine the debate
- Most comments surround the innovative proposals
  – For example, contingent convertible debt, living wills
  – We lack effective models to assess their market viability
  – How useful should we expect living wills to be in resolutions?

Causes of the Crisis <u>should</u> influence reform

- Ineffective Banking and Investment Bank Regulation
  – Prudential Regulation's failure to measure risk
    - OK – but now what?
  – "Not **mainly** a leverage arbitrage story" **Really?**
    - Could still be imp't? Leverage a big deal at Lehman, BS
  – On balance sheet measurement of risk flawed
  – Off-balance risk even more problematic

- Agree about risk mis-measurement – but will regulatory measurement of risk generate any regulatory action?

Key Regulatory Reform Issues

- Can we make Living wills a part of the solution?
  - It is facing major resistance
    - Banking industry seems insulated
  - How to coordinate across borders?
    - Recent IMF meetings suggest that the outlook is challenging

- "Properly designed" Contingent Convertible Bonds
  - **Great idea** – some big questions – is there a market for them?
  - What will be the required return?
    - How costly will they be to issue? Costly, but not as costly as new equity during a crisis – but how much less costly than simply more equity?

Additional Reform Ideas

- Liquidity standards alongside capital standards
  - Very much support – but again, implementation requires some industry input (without foot dragging)

- I share a concern about the Macro Prudential Role
  - What will be the criteria?
  - What will they do “when bad things happen”?
  - Make the triggers non-discretionary
    - As mentioned -- Borio Drehman 2009

<u>Micro</u> Prudential Discipline Specifics

- 1. Use loan interest rates in measuring the risk weights applied to loans for purposes of setting minimum capital requirements on those loans.
  - How effective would this have been in the recent crisis?
  - Didn’t risky CDOs have relatively low interest rates?

<u>Micro</u> Prudential Discipline Specifics

- 3. Establish a minimum uninsured debt requirement for large banks (a specially designed class of sub debt, best in form of CoCos – contingent capital).
  - As mentioned before, this is a great idea.
  - But need to get market participants interested in it, talking about it, and discussing whether it can be workable.
    - Reminds me of putable subordinated debt in an earlier crisis
- Example: Financial Times, October 12, 2010
  - Raj Singh, chief risk officer at Swiss Re, said the insurance group was not in the market for debt that converts to riskier equity during a crisis and he was "severely concerned". "That's not the kind of bet I'm buying into when I'm buying into bank debt," he said.

<u>Micro</u> Cont'd: Fixing Too Big To Fail

- 4. "**CoCos for large banks probably will take care of much of the problem.**"
- **This seems too optimistic --**
  – Caveat about CoCos –
    - How will these assets be taken up in the market? Who will buy?
    - Will banks fight the introduction of the issuance of these bonds?
  – Perhaps some relevant evidence
  – Richard Grossman and Masami Imai, "Contingent Capital and Bank Risk-Taking: Evidence from British Equity Markets before WW I"
    - Preliminary evidence: banks with larger pools of contingent capital displayed more limited risk taking

Fixing Too Big To Fail

- 5. Good idea: “living will” for largest institutions.
  - What is the likelihood that such plans will be prepared?

  - What about reforming the laws that give BHCs the incentive to increase complexity?

- **6. Hybrid reliance on bankruptcy with special resolution authority triggered by credible determination of real systemic risk.**
  - Key problem: how to keep unwarranted resolutions from happening?
  - Who will trade with institutions headed for extinction?
  - How will regulators “make the call”? Not a good track record so far.

- Agree that “tough love” is not credible
  - Especially now – love wasn’t so tough, was it?

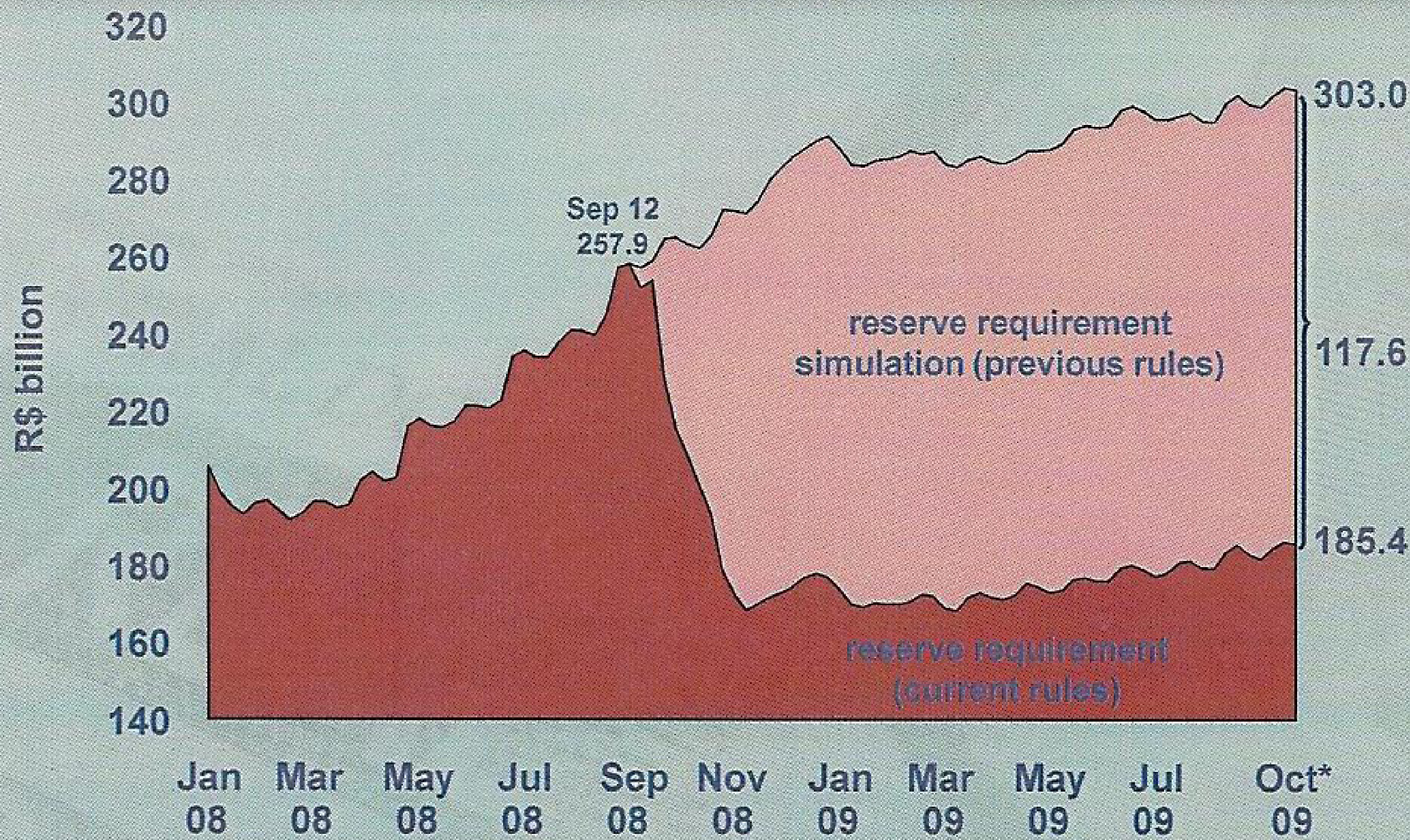
Proper Design of Requirements: Basics

- Remunerative (no reason for a new tax)
- Would be relaxed by regulator during crisis
  - At precisely the time when uncertainty is the greatest, this proposal allows fewer restraints on banks
    - Could this be unsettling to the market?
      - In historical instances, such news was often unsettling
    - Would there be any restriction on bank activities at such times?
- "No arm twisting on interbank lending by the government (that's what LOLR is for)"
  - See next slide --

The Brazil Crisis Response in 2008-2009

- Supportive comments surprised me
- **Private** deposit insurance was **“encouraged”** to extend its coverage for a special assessment
  - Is this “arm twisting”?
- The **private** deposit insurance fund was **“encouraged”** to purchase some loans from banks
  - Is this “arm twisting”?
- Liquid (large) banks were **“encouraged”** to lend to illiquid (smaller) banks
  - Is this “arm twisting”?
- **No LOLR lending was employed**, as bank reserves took pressure off of the LOLR
  - Because private market was **coerced** to deliver the liquidity

Crisis Management (BRL)



Brazil Example

- The outcome **looks good**; the process not so
  - An appropriate solution to the National banking era panics of the US, when no safety net existed
  - **Difference:** Brazil had government influence the private markets to enforce a private solution

- But was not Brazil facing an insolvency crisis the size of the US crisis in 2008-2009?

Limits of Liquidity Requirements

- Is this worth the costs? (e.g., credit supply reduction)
  - Worth investigating – an important question
  - Here is where international evidence, historical examples could be helpful
- Proposal suggestion: Liquidity standard to be met in part (say, up to 50%, as implemented successfully in Argentina in the 1990s) through **standby letters of credit by qualified institutional investors** (which promotes transparency and market discipline)
  - In November 2008, what institutional investor had sufficient credibility with regard to these contracts?
  - How credible would they be if it was perceived that they were over extended?

Final Comments

- Good discussion of key ideas
- Suggestions from international observations
  - These could be useful; need more debate
- Contingent convertible debt – could be helpful
  - Wary of relying too much upon it
  - What will the market price of such debt be?
- Final note: Must **demand** living wills and more information from banks