

Banks, Regulation and Government

- Viral V Acharya (NYU Stern)

- There is a “crisis” when a set of economic agents is holding a significant exposure to an asset class that is funded by short-term debt with redemption rights and there is a common shock to this asset’s quality or providers of short-term debt
- Not just banks, but savings and loans, hedge funds (LTCM), corporations (South East Asian crisis), governments (Europe)...

Crises

- Banks are at the center of asset origination and creation of money (short-term debt with redemption rights)
- Banks have also been at center of crises
- Regulation designed to contain banking crises (e.g., deposit insurance)
- Government creation of “safe” assets can help stabilize banks
- But, regulation and government creation of assets can be problems in themselves

Banks, Regulation, Governments

- Crises may be inevitable in banking
- But the key question is whether their incidence is excessive or efficient?
- How does regulation affect this incidence?
 - Regulation socializes crises-induced losses and externalities (too big to fail, too many to fail,...)
- Key point: Regulation that contains crises (e.g., deposit insurance) increases divergence between socially and privately efficient creation of systemic risk.

What is the effect of regulation?

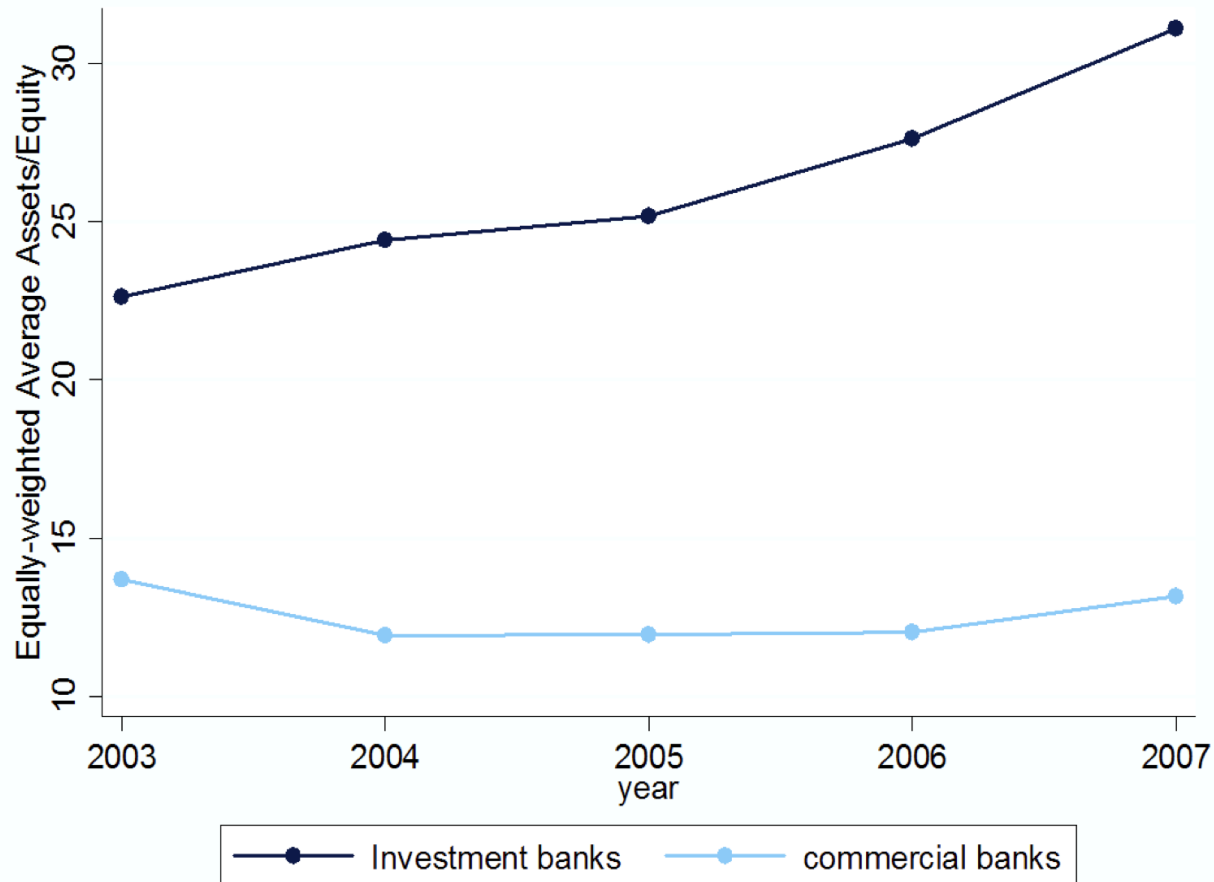
- Regulation ALSO aims to contain ex ante the excessive creation of systemic risk
- But the increasing divergence makes this process fragile and vulnerable
 - Example: Deposit insurance ring-fenced by charter rights, deposit rate ceilings, bank examination, but all are unstable
 - International competition, shadow banks
 - Money market funds
 - Out-gaming of examination: size, complexity, cognitive capture...

Effects of this divergence

- “Shadow banks” thus do not just represent the desire to create private money, but also reflect greater divergence between intermediaries and regulation
 - Without excess to crisis-stabilizer, competition for funds implies that shadow banks must operate at greater leverage/risk
 - Banks with access to crisis-stabilizer respond by regulatory arbitrage (conduits, SIVs, ...)
- Fragile and vulnerable regulation can thus indeed be a problem in itself

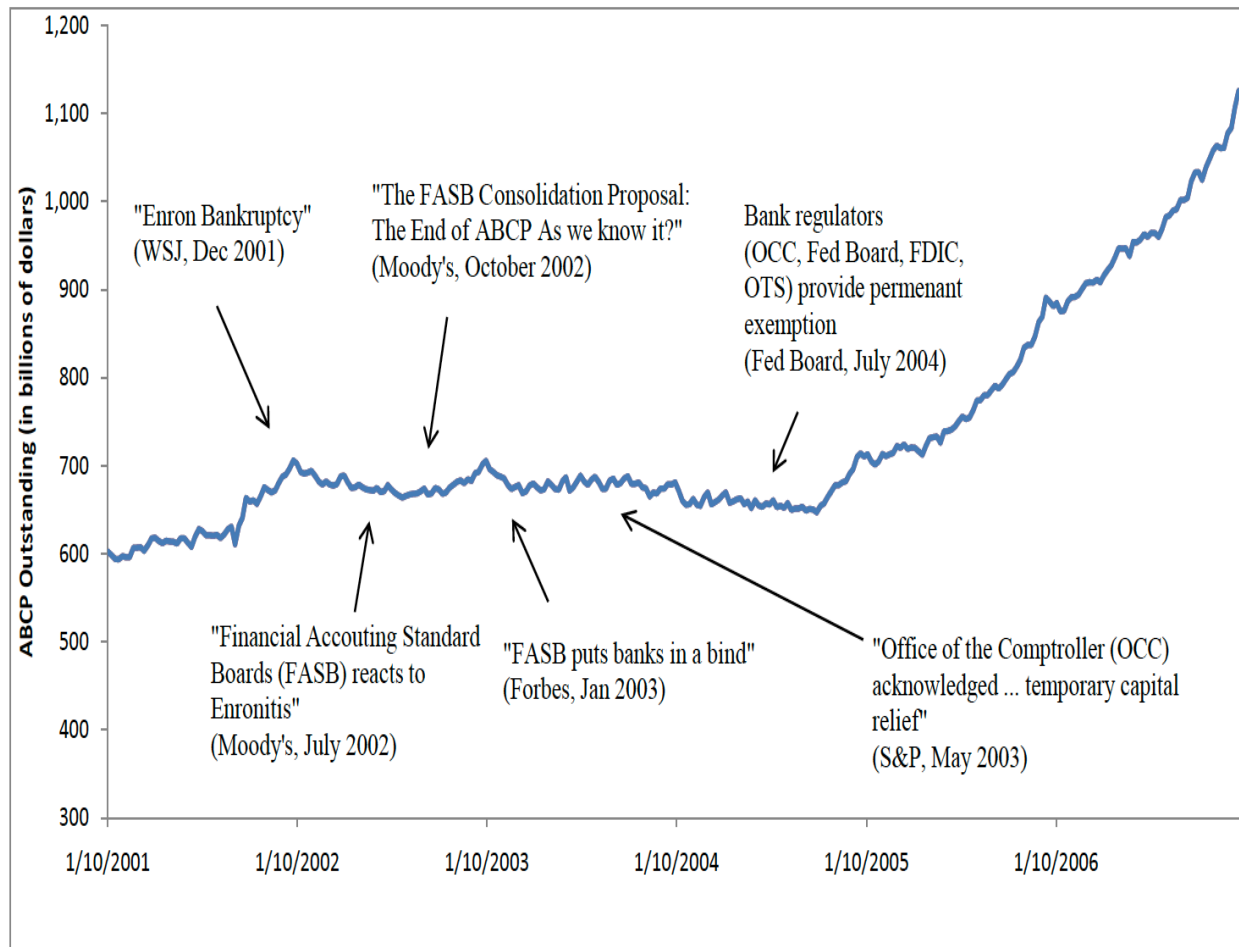
Race to the bottom – I

Investment banks versus Commercial banks leverage



Source: *Guaranteed to Fail* (Acharya, Richardson, Van Nieuwerburgh, White)

Commercial bank leverage (money) explosion



Source: "Securitization without risk transfer" (Acharya, Schnabl, Suarez)

- If only all that governments did was to create a perfectly safe asset...
- Governments should be viewed as economic agents, with an objective to please their principal (the median voter), but with much shorter horizon and much discretion at hand, creation of “safe” asset and allocating proceeds being one of them

Governments and safe assets

- Governments may stabilize banks in a financial crisis
 - Deposit insurance
 - Nationalization
 - Bad banks
 - (Central banks)
- The creation of money and short-term debt is partly transferred to another agent
- This can thus be a problem in itself

Crisis stabilization

- The government-sponsored enterprises (GSE's) of the United States are a classic example of this divergence between the government and the society
 - Fannie Mae created in aftermath of the Great Depression to boost mortgage finance
 - All great until 1968...
 - Even ok until 1992... Then a "mission creep"
 - And then a race to the bottom with private sector in 2003-07

Fannie Mae (and Freddie Mac)

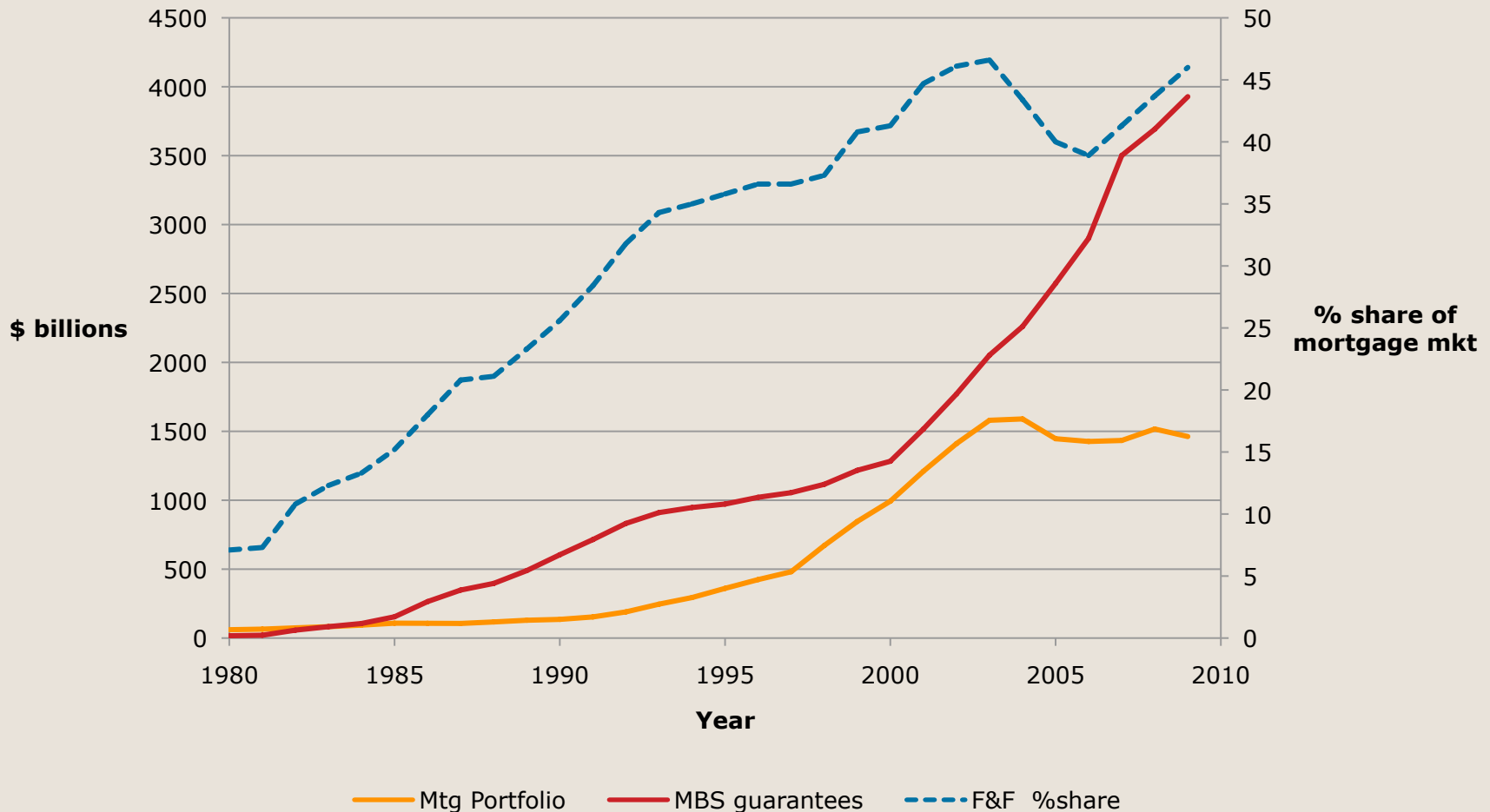
Why Did Fannie Mae Go Private in 1968 and What Does That Tell Us About Their Eventual Failure and the Current Budget Problems?

Why were all the “money”-like properties of GSE debt and securities preserved to be as special as Treasuries?

This government money became heavily conflicted...



Why Did the GSE Growth Look Like This?

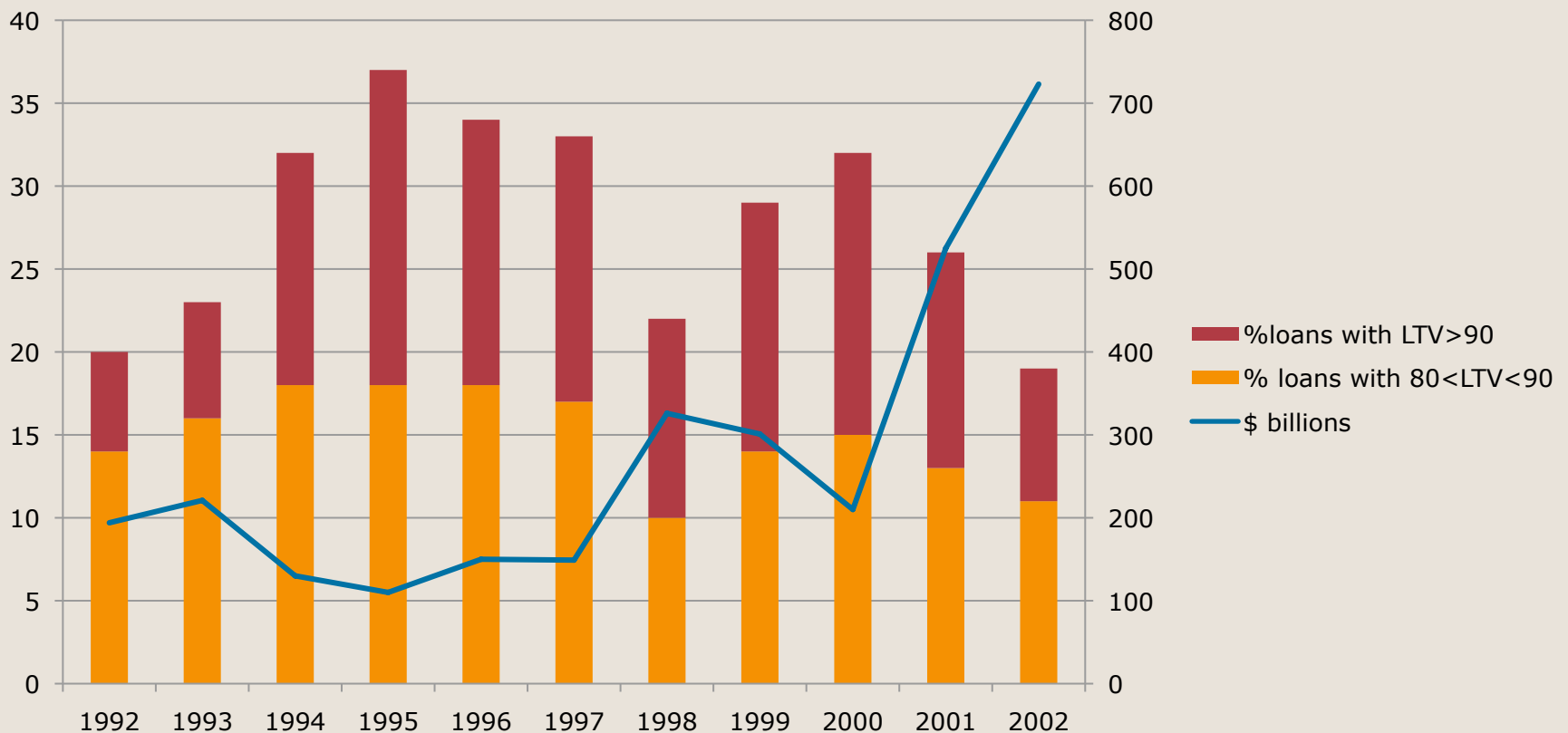


Source: *Guaranteed to Fail* (Acharya, Richardson, Van Nieuwerburgh, White)

- Government “guarantee” of GSE debt and MBS guarantee.
 - 40bps lower cost of financing & lower cost of issuing MBS, resulting in \$7 billion subsidy in 1996, \$13.5 billion in 2000.
- Private sector was crowded out, but...
- Regulatory capital arbitrage.
 - The financial system only had to hold 2.50% capital if GSE’s were involved, versus 4% capital if banks or thrifts held un-securitized (“whole loan”) residential mortgages.

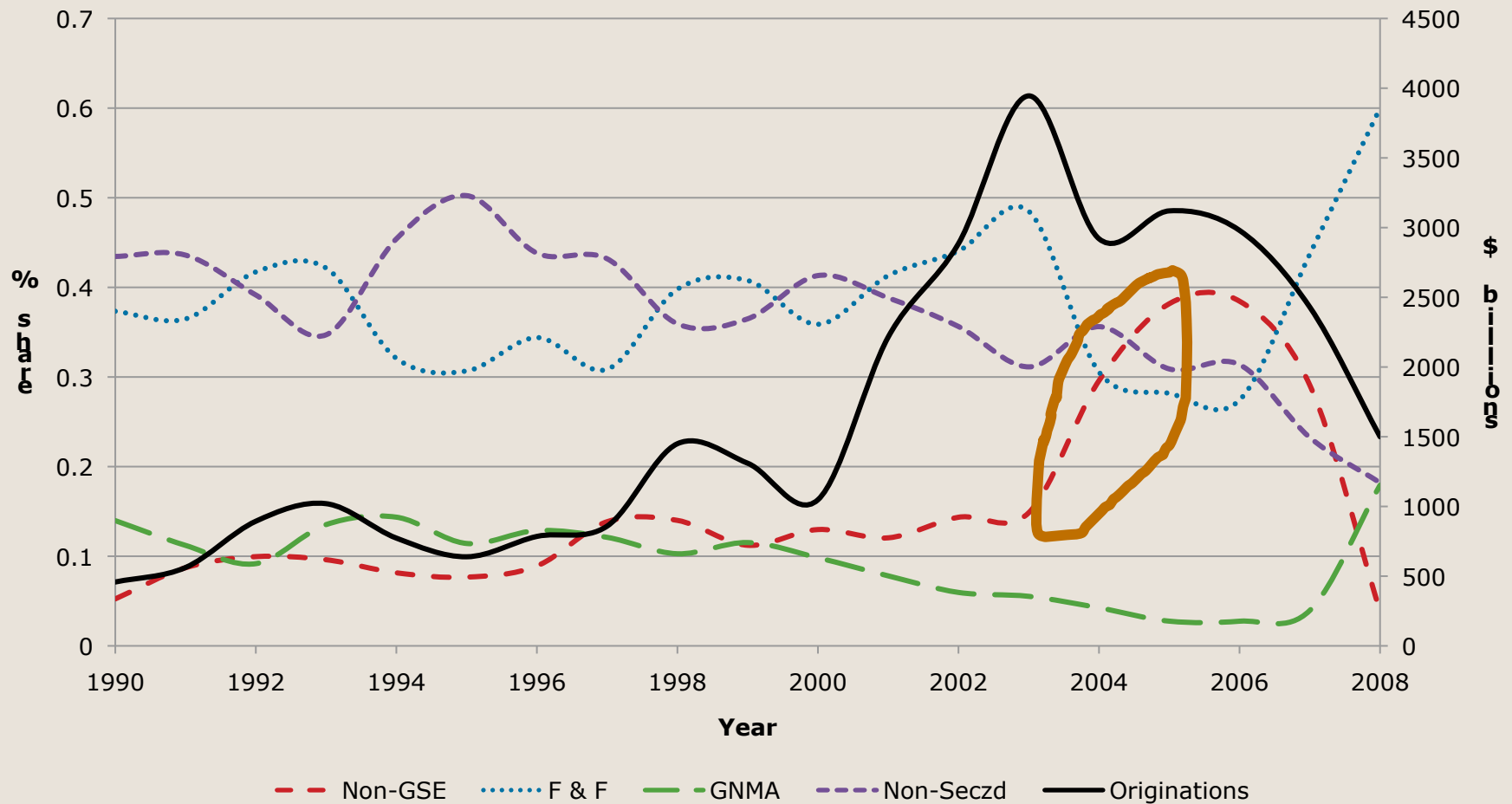
Two Main Reasons

Race to the Bottom II: When Did the GSEs Start Taking on "Risky" Mortgages?



Source: Fannie Mae

The SubPrime Securitization Market Took Off



Source: *Guaranteed to Fail* (Acharya, Richardson, Van Nieuwerburgh, White)

How Did the GSEs React?

“Our business model – investing in and guaranteeing home mortgages – is a good one, so good that others want to ‘take us out’...Under our new strategy, we will take and manage more credit risk, moving deeper into the credit pool to serve a large and growing part of the mortgage market.”

Fannie Mae confidential strategic plan document, 2006

Billions	GSE New business		GSE Portfolio	GSE Portfolio	Non-Agency MBS	Total Market New business (Non Agency)		GSE High Risk %	GSE share in High risk activity
	High risk (1)	Total (2)	PLS	Total	High Risk	Total High Risk (3)	Total	(1)/(2)	(1)/(1+3)
2003	466	1839	103.2	794	336	625	3945	25%	43%
2004	262	898	211.8	400	605	1060	2920	29%	20%
2005	236	899	221.3	388	891	1370	3120	26%	15%
2006	245	877	180	344	904	1430	2980	28%	15%
2007	363	1012	113.5	300	495	815	2430	36%	31%

Source: FHFA

- Runs and panics clearly central to crises
- BUT, how much risk of runs and panics to take on is in control of economic agents, even if their incidence be uncertain
- Examining divergence between private and social incentives in taking on this risk is a useful paradigm for modern crises
 - Socialization of crises losses and externalities
 - Fragile and vulnerable regulation
 - The Dodd-Frank Act
 - Moral hazard of governments

History useful, but need a new lens

- The Dodd-Frank Act represents an attempt to put resilience into the complex web of shadow banks and money creation we have created over past 75 years
- Response to second half of “Quiet Period” that sowed seeds of the crisis of 2007-09
 - FSOC (SIFI’s): contain systemic risk divergence
 - FDIC’s report on Lehman shows promise, even in dealing with repo/derivative runs
 - Hedge funds and money market funds remain important unresolved issues

The Dodd-Frank Act

- We have relied far too much on down-side regulation like deposit insurance and liquidity facilities
- We have also relied far too much on government balance-sheets
- Divergence between private and social levels of systemic risk grown far too much
- We need to put back “genie in the bottle”
- European woes and US debt outlook are good lessons... to all who heed them!

The “Genie in the Bottle” Problem