

# Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK  
*of* CLEVELAND

## The Future of Financial Market Regulation

### **INSIDE:**

Slowing Speculation in Housing

Introducing the  
Cleveland Financial Stress Index

A Bad Bank, for the Greater Good

### **PLUS:**

Interview with Charles Calomiris

# Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK  
of CLEVELAND



*The views expressed in Forefront are not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System. Content may be reprinted with the disclaimer above and credited to Forefront. Send copies of reprinted material to the Public Affairs Department of the Cleveland Fed.*

Forefront  
Federal Reserve Bank of Cleveland  
PO Box 6387  
Cleveland, OH 44101-1387

forefront@clev.frb.org  
clevelandfed.org/forefront

WINTER 2011

Volume 2 Number 1

## CONTENTS

- 
- 1 President's Message
- 
- 2 Reader Comments
- 
- 4 Upfront  
Unemployment Benefits: Help or Hindrance?
- 
- 6 Rules and Regulations  
How the Details Take Shape
- 
- 10 Early Warning  
Introducing the Cleveland Financial Stress Index
- 
- 12 How to Build a Bad Bank  
For the Greater Good
- 
- 16 Keeping Banks Strong  
Conference on Countercyclical Capital Requirements
- 
- 20 Slowing Speculation  
A Proposal to Lessen Undesirable Housing Transactions
- 
- 26 Interview with Charles Calomiris  
Columbia University banking scholar appraises regulatory reform
- 
- 32 Book Review  
*All the Devils Are Here*
- 

**President and CEO:** Sandra Pianalto

**Editor-In-Chief:** Mark Sniderman,  
Executive Vice President and Chief Policy Officer

**Managing Editor:** Robin Ratliff

**Editor:** Doug Campbell

**Associate Editors:** Amy Koehnen, Michele Lachman

**Art Director:** Michael Galka

**Designer:** Natalie Bashkin

**Web Managers:** Stephen Gracey, David Toth

**Contributors:**

O. Emre Ergungor	Dan Littman
Thomas Fitzpatrick	Lou Marich
Elizabeth Hanna	April McClellan-Copeland
Joseph Haubrich	Jennifer Ransom
Natalie Karrs	

**Editorial Board:**

Ruth Clevenger, Vice President, Community Development  
Kelly Banks, Vice President, Community Relations  
Stephen Ong, Vice President, Supervision and Regulation  
James Savage, Vice President, Public Affairs  
Mark Schweitzer, Senior Vice President, Research  
James Thomson, Vice President, Research





CHRIS PAPPAS

## Interview with Charles Calomiris

Charles W. Calomiris is not one to keep his thoughts to himself. His 55-page curriculum vitae lists dozens of academic articles with titles like “Firm Heterogeneity, Internal Finance, and Credit Rationing”—and just as many op-eds in popular periodicals, like the *Wall Street Journal* piece, “Blame Fannie Mae and Congress for the Credit Mess.” It is not unusual for him to begin scratching out an editorial response to new legislation moments after he first hears about it in the news. A more outspoken and influential U.S. banking scholar you are not likely to find.

Calomiris is the Henry Kaufman Professor of Financial Institutions at the Columbia University Graduate School of Business and a professor at Columbia’s School of International and Public Affairs. Among his many other affiliations, he is a member of the Shadow Financial Regulatory Committee, the Shadow Open Market Committee, and the Financial Economists Roundtable, and is a research associate of the National Bureau of Economic Research. He has worked as an economist for the Federal Reserve and consulted for central banks around the globe.

Calomiris visited the Federal Reserve Bank of Cleveland last fall to participate in the Conference on Countercyclical Capital Requirements. Joseph Haubrich, vice president and economist with the Bank, interviewed Calomiris on October 14, 2010. An edited transcript follows.

**Haubrich:** *Let's start out with a broad question. How would you rate the U.S. response to the financial crisis?*

**Calomiris:** It's a great question. I would start by distinguishing between long-term response and short-term response. I'd say that the biggest short-term failure was not to require recapitalization of the investment banks between March and September of 2008. I would have liked to have seen recapitalization happen during calm markets when it was obviously necessary.

Also, with respect to the immediate response to the crisis, I would have designed TARP [the Troubled Asset Relief Program, signed into law in October 2008] differently. I don't think TARP was well-structured. Congress got to write the form of capital assistance for banks as a footnote to TARP, and it was structured to make a profit on the transactions rather than to encourage the right kind of stabilization assistance.

In many ways, our response in the 1930s was better. I think there were lessons from history that we could have put to use in this crisis. And we suffered a lot, unnecessarily, with a liquidity crisis that wouldn't have been so deep if we had used better ideas back in September and October 2008 about how we were going to support the financial system.

The Fed's short-term actions were mostly appropriate — making liquidity available to the markets in various forms, particularly TALF [Term Asset-Backed Securities Loan Facility]. I think this was a successful and warranted program. It conforms to what I take to be the central message of a what a lender of last resort has to do, which is try to take some risk on its balance sheet during a crisis, but to do so in as senior a way as possible. I'm not saying the Fed got everything right.

I think that the Dodd–Frank bill,<sup>1</sup> which is the main form of long-term response to the crisis, suffers from both sins of commission (bad ideas enacted in haste) and sins of omission (it doesn't really deal with some of the key problems that underlay the crisis).

The key problems that we should have learned about from a prudential regulatory standpoint were, number one, the subsidization of risk in housing through high leverage, effectively financed by the government, either explicitly or implicitly. We need to address that. Second is the failure to accurately measure risk in the financial system on a forward-looking basis and to require capital accordingly. Going forward, we really need to address that problem, too. And third is the too-big-to-fail problem. I don't think Dodd–Frank adequately tackled that problem.

**Haubrich:** *Part of the Dodd–Frank bill was setting up a variety of institutions, such as FSOC [Financial Stability Oversight Council], which are presumably going to provide stricter regulation for the systemically important or too-big-to-fail institutions. Do you think that will be an adequate response?*

**Calomiris:** My view is that we should have an incentive scorecard for any regulatory idea that asks how it is going to affect the incentives of people in the marketplace directly. And how is it going to affect the incentives of regulators, supervisors, and politicians to live by the rules they write? The creation of a new bureaucracy is not really getting at that in any direct way. Maybe it will help, maybe it will hurt. But it doesn't really get at the key problems.

I prefer other ideas that are under study and make a lot of sense. Contingent capital certificates and the restructuring of capital requirements are very promising. There are several people in the Federal Reserve System who are interested in that. If the oversight council is going to be a way to get

good ideas like that formulated, then in conjunction with those new ideas it could be effective. So, it's not a bad idea that we're going to have more of a focal point on responsibility for coming up with good ideas in some coordinated way. Maybe it will help, maybe it won't. But the ultimate test is going to be whether we see real mechanisms that matter for incentives coming out of those deliberations.

**If there is a bona fide reason to promote affordable housing, it's to create stakeholders in local communities. But you're not a stakeholder if you have a 3 percent down payment on your home—you are a renter in disguise.**

**Haubrich:** *You mentioned one aspect that hasn't been dealt with: the incentive for leverage in the housing market. What would you do about the government-sponsored enterprises Fannie Mae and Freddie Mac?*

**Calomiris:** I think that they should be phased out. I think that all government assistance to housing that's taking the form of lending programs that try to subsidize affordable housing through making lending easier, and especially through very high leverage and very low interest rates, are the wrong way to subsidize housing, for two reasons: First, it encourages systemic risk, just like what we've experienced. A little bit of a decline in housing prices causes huge distress throughout the financial system, precisely because of leverage.

Also, leverage encourages the wrong kind of risk that comes to the market because borrowers are not placing enough of their own resources at risk; people who are bad risks are willing to come to the mortgage market. So you get a bad incentive consequence in advance. Leverage also matters after the fact, by magnifying the losses in the financial system created by recession shocks or asset price declines.

1. Dodd–Frank refers to the financial-market, regulatory-reform legislation, sponsored by Sen. Christopher Dodd and Rep. Barney Frank, which was approved by Congress in July 2010.



**We will need the political will to move away from the drug of leverage, which was attractive to politicians in the first place because it disguised the government's costs.**

If leverage is not the way to promote affordable housing, then that means it is high time to phase out FHA [the Federal Housing Administration], Fannie Mae, and Freddie Mac.

Not only is mortgage risk subsidization through high leverage risky, it also fails to achieve its goal. If there is a bona fide reason to promote affordable housing, it's to create stakeholders in local communities. But you're not a stakeholder if you have a 3 percent down payment on your home — you are a renter in disguise. These extremely low down payments are a very recent trend, really the last two decades. It was all part of the desire to create invisibly — from a fiscal standpoint, that is, without showing the costs on the government's balance

sheet — these government supports, through high leverage and subsidized interest rates. But this approach doesn't accomplish the housing objective, and it destabilizes the mortgage market and creates large costs to taxpayers.

**Haubrich:** *OK, so what specifically would you do to ensure that homebuyers are stakeholders in their communities?*

**Calomiris:** I propose a four-part plan: Alongside phasing out Fannie Mae, Freddie Mac, and FHA as lending agencies, *my proposal* is to create a down payment assistance program modeled after the Australian program but on a means-tested basis. Every Australian qualifies for a \$7,000 first-time homebuyer subsidy. This subsidy increases their down payment, reduces their leverage, and makes their home more affordable. It has a stabilizing effect on leverage ratios and creates a real stake for people in their homes and communities.

A second part of that plan is to phase in, over a 17-year period, movement from the minimum 3 percent down payment requirement to a 20 percent minimum. A third policy that might also make sense, again on a means-tested basis, is to provide some assistance for the cost of locking in longer-term interest rates for low-income people because they're potentially more susceptible to the debt-service fluctuation cost.

Finally, a fourth part of that plan might be to create home savings accounts that provide tax incentives for people to accumulate equity toward the down payment, again on a means-tested basis. As part of that, it would be interesting to think about also using some tax savings from payroll taxes, because most low-income people don't pay income taxes; they pay only payroll taxes.

All of these proposed costs would be budgeted explicitly. Let's have transparency so we show the government expenditure effects of these programs. Let's create systemic stability, not instability. Let's create homeowners, not renters in disguise. To me this would be a very rational approach to housing finance reform. We will need the political will to move away from the drug of leverage, which was attractive to the politicians in the first place because it disguised the government's costs. Well, it's a little hard to disguise them now that the costs of Fannie Mae and Freddie Mac's losses are likely to top \$300 billion. Maybe that means we'll get the political will to be a little more honest.

**Charles W. Calomiris**

**Current Position:**

Henry Kaufman Professor of Financial Institutions, Columbia Business School; and professor, Columbia University School of International and Public Affairs

**Other Positions:**

Research associate, National Bureau of Economic Research, October 1996–present (faculty research fellow, October 1991–October 1996)  
Member, Shadow Financial Regulatory Committee, December 1997–December 2004 and December 2005–present  
Member, Financial Economists Roundtable, November 2007–present

Member, Shadow Open Market Committee, April 2009–present

**Books:**

*U.S. Bank Deregulation in Historical Perspective*, Cambridge University Press, 2000, 2006  
*Emerging Financial Markets* (with David O. Beim), McGraw-Hill, 2000

**Education:**

Yale University, BA, 1979  
Stanford University, PhD, 1985



**Haubrich: Let me switch gears and talk a little bit about the subject of the conference we're hosting. Can counter-cyclical capital regulation work?**

**Calomiris:** I think it can. First let me define it. We know that capital requirements can constrain bank lending under some circumstances. It's not just government capital requirements but also market capital requirements. Remember, government capital requirements are only about 30 years old in the United States, and we were the first country that I'm aware of that passed them.

Capital requirements mean requiring a certain ratio of your assets to be in the form of equity capital. It's a fairly young idea. Before the government required it, the market required it. Now both the government and the market require it. The one that's the binding constraint—the one that has the effect in determining capital requirements—is whichever is the higher of the two.

People are worried about two problems. First, during recessions, banks may lose capital as a result of loan losses. For example, during a recession, to preserve their capital-to-asset ratio, they may have to cut their risky assets, meaning their loans. The other thing people worry about is that going into booms, that constant capital ratio maybe isn't high enough to discourage excessive lending.

These are the two arguments people make for dynamic capital requirements; that is, maybe we want capital requirements to be higher during booms as a way to discourage excessive lending. And maybe we want capital requirements to fall during recessions as a way to avoid really severe credit crunches. I think there is at least some evidence for the tendency for excessive lending in *some* booms. I don't think it's a general problem, but it does happen occasionally.

The key question is whether we can measure it. Can we measure when lending markets are excessive and when lending markets are going through recessions? We'd like to vary capital requirements—to relax them during recessions and to increase them during booms, especially booms where we're very worried about excessive lending. Is this something that can be measured? I would say yes. It can't be measured perfectly but it can be measured fairly well.

A paper by Claudio Borio and Mathias Drehmann at the BIS [Bank for International Settlements] showed that very severe recessions tend to happen when lending growth is very high just prior to the recession, during the boom, and when asset prices are growing very fast. So one could impose higher capital requirements based on a dual threshold. When loan growth gets very high and asset prices are growing very quickly, you'd like to impose higher capital requirements, and doing so will help you achieve a better soft landing, cooling down the loan growth and helping the economy.

**Haubrich: Now capital requirements are changing. Basel III<sup>2</sup> is coming up with a set of recommendations. Could you give us your take on those proposals?**

**Calomiris:** They're talking about phasing in an increase in capital requirements for Tier 1 capital. It's a maximum leverage requirement rather than just a risk-based capital requirement. These are good ideas. But are they enough? No.

A little increase in capital doesn't solve the problem. The key problem was the failure to measure risk on an ongoing, forward-looking basis, fairly accurately, and to require capital accordingly. If you just bump up capital a little bit, what's to prevent risk from going up even more? If financial institutions want to create risk and want to hide it from their regulators, under the existing Basel system it's almost trivial to do it. The Basel system still,

unbelievably, says that the way we measure risk is asking banks what the risk is and asking ratings agencies what the risk is. That is not dealing with the incentive problems that got us into the mis-measurement of risk in the first place, so we have to think more creatively about mechanisms that can solve this problem.

**The Basel system still, unbelievably, says that the way we measure risk is asking banks what the risk is and asking ratings agencies what the risk is.**

One paper that was published in 2003 by Don Morgan and Adam Ashcraft in the *Journal of Financial Services Research* shows that interest-rate spreads on loans are very good predictors of loan default risk. In the common parlance we would say, "Duh!" Because after all, that's the point of spreads. They're supposed to compensate banks for risk.

The authors showed in 2003 that we could've used interest rate spreads as good forward-looking measures of risk. We didn't use them! If we had used them in the subprime crisis, we would've budgeted a lot more capital against subprime risks and we would've been better off. So ideas coming out of Basel to tweak capital requirements in a way that's not related to measuring risk are doomed to fail.

What we need to do is take risk measurement seriously in a way that deals also with incentive problems. Notice that my proposal to gear default risk measures to loan spreads is incentive-robust. Why? Because no bank is going to cut its interest rate to save a little bit on its capital requirements. That means that interest rates will provide robust measures of risk, and we can therefore reliably use those interest-rate spreads to measure risk.



2. The Basel Committee on Banking Supervision has been meeting since 1974 to improve and coordinate the quality of bank supervision worldwide. The most recent effort to strengthen capital requirements was dubbed Basel III.

That's just one of several ideas that illustrate the idea of incentive-robust regulatory reforms. These reforms would sometimes force banks to maintain more capital—but capital commensurate with risk—using measures of risk that we could rely on.

**Haubrich:** *Some people argue that high-enough capital requirements would reduce the incentive that banks have for taking risk. It sounds like you don't agree with that?*

**Calomiris:** The problem is that financial firms are designed to be able to arbitrarily increase risk. Financial contracts can reshape and re-cut risk in many different ways to create a little risk or a lot of risk, depending on what they want to achieve. You can't say that a loan has X amount of risk, because banks can construct loans that might appear very similar that have very different kinds of risk. We have to have a flexible means of measuring risk.



### **What we really have to ask is what was missing in regulation. What was missing was what we've been talking about: accurate measurement of risk on a forward-looking basis.**

If we just say we're going to increase capital a little bit, banks could very easily just make sure that the composition of risks of the loans in their portfolio are commensurately higher, therefore achieving nothing in terms of stabilizing a system. That's the story of what is sometimes called regulatory arbitrage, that is, the private sector undoing the effect of any regulation. If the regulations are dumb, the private sector will always smartly undo them. The regulations have to be smart enough so that they're robust to incentives.

**Haubrich:** *To follow up on that, to what extent do you think the problem behind the crisis was, say, regulatory arbitrage, and to what extent was it deregulation?*

**Calomiris:** I'll start with the second part of the question. Deregulation had nothing to do, in my view, with the crisis. The main deregulation that happened in the United States in the 1980s and the 1990s really dealt with two important issues. One of them was whether banks should be allowed to branch throughout the United States. In 1994, national deregulation of branching was a culmination of state and regional deregulation of branching that was occurring throughout the '80s and early '90s. That was a stabilizing policy. It has been shown time and time again for a whole host of reasons to be a very good idea as a matter of economic policy.

The other main deregulation was for banks and investment banks. It allowed banks to engage in the underwriting of corporate securities, which they previously had been limited in doing. This crisis had nothing to do with the underwriting of corporate securities.

Furthermore, subprime mortgage activities, which were important in creating the crisis, were something banks could have engaged in prior to the two deregulations I've talked about, and in fact did. Deregulation allowed commercial banks to engage in traditional investment-banking and corporate-underwriting practices, and allowed commercial banks to branch. These were stabilizing, in fact, during the crisis.

Why? Because of greater diversification of income. Furthermore, remember, the way we dealt with this crisis was by allowing investment banks to be purchased by commercial banks. That was possible because of deregulation, and it helped to stabilize the system in reaction to the crisis.

When you hear the political rhetoric about deregulation, I think what people really mean is that we had a failed prudential regulatory system. Banks and investment banks were both under prudential regulation under the Basel standards. The investment banks were being regulated, under Basel, by the SEC [Securities and Exchange Commission]. And what we can say is that it wasn't a very good regulatory system. We did not maintain capital commensurate with risk very effectively. But starting in 2002, the investment banks were all regulated, long before this crisis hit. If anything, prudential regulation was increasing over time during the phase when the crisis took hold.

What we really have to ask is what was missing in regulation. What was missing was what we've been talking about: accurate measurement of risk on a forward-looking basis. The other problem that arose between March 2008 and September 2008 was that once we bailed out Bear Stearns, others expected bailouts instead of recapitalizing as they needed to. They didn't want to recapitalize in a way that would dilute their stock values. Why not take a bet, hope that if things go badly they'll get bailed out? If things go well, they won't have to dilute by issuing new equity. That too-big-to-fail problem needs to be addressed, too. We've done little to address those two basic problems.

**Haubrich:** *We haven't talked much about monetary policy. Do you think monetary policy contributed in a material way to the financial crisis?*<sup>3</sup>

**Calomiris:** Yes. From 2002 to 2005, the real federal funds rate was negative. And the only other four-year period in postwar history where that was true was 1975 through 1978, the high-inflation period. If you looked at it from the standpoint of the Taylor rule as a function of the unemployment rate and the inflation rate, the Fed stopped following the Taylor rule during the period 2002 to 2005.<sup>4</sup>

The Fed kept the fed funds rate about 2 percentage points on average below what that rule would have implied. So the Fed surprised the market from the standpoint of the Taylor rule, ran very loose monetary policy with a negative real fed funds rate, and there is pretty convincing statistical evidence that this contributed to the underpricing of risk leading up to the crisis.

That said, I can tell you from a historical perspective that monetary policy mistakes like that — and I regard it as a mistake — do not cause these kinds of crises. They cause asset-price problems, but to get into a banking crisis you need the large losses relative to bank capital, and you can't blame that on monetary policy. Contrast, for example, with the dot-com boom and bust, where the actual losses were greater than the subprime boom and bust. Yet it didn't have any effect on the whole financial system. Why? Because it wasn't a leveraged loss. Housing leverage and banking leverage in the recent crisis translated into an overpricing of some assets and into the demise of the financial system.

Yes, the Fed contributed to the overpricing of real estate assets and other assets, but that doesn't translate into a financial crisis. You need the other distortions on the microeconomic side, particularly the housing finance distortions, to really understand the depth of the crisis.

**Haubrich:** *Thank you very much.* ■

3. For Federal Reserve Chairman Ben Bernanke's take on this question, see [www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm](http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm).

4. The Taylor rule is the monetary policy rule for targeting the federal funds rate that many believe the Fed seemed to be following prior to 2002.



Watch video clips of this interview

[www.clevelandfed.org/forefront](http://www.clevelandfed.org/forefront)