

SEIR (Structures Early Intervention and Resolution): The U.S. Response to the S + L Crisis of the 1980s. What It Did, Why It Failed, and Where to Now

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Primary Problem

- Misuse and mispricing of bank safety net-- deposit insurance, Fed discount window and other government guarantees.
- Consequences
 - Banks - - -Moral hazard excessive risk taking, including low capital.
 - Regulators - - - Poor agency excessive forbearance behavior.

Attempted Solution

- In U.S., PCA and LCR in FDICIA of 1991
- Theory
 - Mimic for regulated firms sanctions market imposes on nonregulated firms(simulate market discipline).
 - Regulatory sanctions applied progressively harsher and with less discretion (more mandatory) as financial health of bank deteriorates to turn bank around (PCA).
 - More harshly —————> Reduces bank risk taking
 - Less discretionary —————> reduces regulator forbearance

PCA Features

Summary of Prompt Corrective Action Provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991

Zone	Mandatory Provisions	Discretionary Provisions	Capital Ratios (percent)		
			Risk Based Total	Tier 1	Leverage Tier 1
1. Well capitalized			>10	>6	>5
2. Adequately capitalized	1. No brokered deposits, except with FDIC approval		>8	>4	>4
3. Undercapitalized	1. Suspend dividends and management fees 2. Require capital restoration plan 3. Restrict asset growth 4. Approval required for acquisitions, branching, and new activities 5. No brokered deposits	1. Order recapitalization 2. Restrict inter-affiliate transactions 3. Restrict deposit interest rates 4. Restrict certain other activities 5. Any other action that would better carry out prompt corrective action	<8	<4	<4
4. Significantly undercapitalized	1. Same as for Zone 3 2. Order recapitalization 3. Restrict inter-affiliate transactions 4. Restriction deposit interest rates 5. Pay of officers restricted	1. Any Zone 3 discretionary actions 2. Conservatorship or receivership if fails to submit or implement plan or recapitalize pursuant to order 3. Any other Zone 5 provision, if such action is necessary to carry out prompt corrective action	<6	<3	<3
5. Critically undercapitalized	1. Same as for Zone 4 2. Receiver/conservator within 90 days with two possible 90 day extensions 3. Suspend payments on subordinated debt 4. Restrict certain other activities				<2

SOURCE: Board of Governors of the Federal Reserve System.

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- If bank does not turn around, terminate charter (close legally) at 2% before capital depleted and turns negative (LRC). Allowed by special bank insolvency resolution regime (SRR). In theory, if successful, loss only to shareholders.
- If unsuccessful and capital negative, cannot protect uninsured depositors/creditors or shareholders. Must share in losses. FDIC stands in shoes of insured depositors.

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- But exception. If LCR threatens financial stability, systemic risk exemption(SRE) can invoked—TBTF. Externality concern. But made difficult to achieve. 5 hurdles:

- | | | |
|---------|---|---|
| Ex-Ante | { | <ul style="list-style-type: none">• 2/3 vote of FDIC and Fed• Approved by SOT after consultation with President• Notification of Congress |
| Ex-post | { | <ul style="list-style-type: none">• Audit by GAO• If loss to FDIC, special ex-post assessment on banks |

How it Worked?

- Fine between 1992 and 2006. Large percent of undercapitalized banks turned around or sold prior to failure. When failures, no uninsured depositors/creditors protected outside LCR. No SREs invoked.
- But
 - Low number of failures
 - No large bank failures
 - Loss rate to FDIC high, about 20% (due to small bank size and fraud)

Why Break Down After 2007?

- Stopped working for LCR, no evidence on PCA
- Number of bank failures increased
- Large (“systemic”) banks and bank-like financial institutions failed
- Never meant to work in crisis (Basically microprudential policy)
- Regulators caught unprepared
 - Insufficient manpower (overwhelmed)
 - Insufficient mental toughness
 - Lack of foresight
 - Political interference
- Regulators frightened if admit large bank failure and problems. Protect financial stability.
- Regulatory “capture”

Cont

- As result, regulators practiced forbearance:
 - PCA → NP NC NA
 - LCR → Delayed closure long after 2%
- FDIC loss rates increased to 20-40%
- Agency problem not solved.
- PCA/LCR (FIDCIA) only as effective as regulators permit it to be!

Implications for Future U.S. Regulation

- Regulation pendulum likely to swing from near one extreme to the other.
- Because causes of crisis not yet fully identified, new regulations will be primarily knee-jerk, ad hoc and politically directed (regulatory “deform”), e.g., rearrange bureaucratic furniture.
- Financial sector widely seen as too “sophisticated, innovative, risky.” Potential for major breakdowns with serious harm to others. Remedy--slow down by throwing sand into gears. Heavy handed regulation- - visible hand of government.
- Expand beyond banks to large, complex, bank-like financial institutions.

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- In US, new regulations likely to have similar effects to those of 1930s. Safety over efficiency. Time inconsistent outcome - - favorable effects precede later adverse effects. Sacrifice future economic growth.
- Through time, as technology improves and adverse effect on efficiency and profit opportunities are perceived by participants, regulatory avoidance and evasion will reappear as in 1970s and 1980s and heavy handed regulations eased.
- Part of problem leading to crisis was not lack of regulation (regulatory failure) but lack of enforcement of existing regulation (regulator failure). Big principal-agent problem.

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- But some important regulations not adopted. These should be adopted now but correctly:
 - Higher capital requirements for all banks.
 - Additional higher capital requirements for large, complex, and interconnected financial institutions (not systemically important). Macroprudential policy to supplement microprudential policy.
 - Better designed resolution regime for large, complex, and interconnected financial institutions that emphasizes market discipline and ends TBTF. More administrative than judicial. Regulators can help shape resolution process and outcome. Danger of excessive regulator power. Need LCR criterion.
 - Restrictions on asset and funding liquidity.
 - Greater emphasis on financial stability to match monetary stability.
 - Expand PCA and do it right. Keep SEIR as microprudential policy.

Cont

- Recognize that never likely to achieve “never again.” Financial crises nearly every 10-20 years in nearly all economies that have operating financial sectors, regardless of economic structure --market or planned. Be prepared!
- Need to be careful that neither
 - Throw out baby (financial system) with the bathwater
 - Destroy economy to save it
- Haste makes waste.

Thank You