

# **G-20 summit: Clash of priorities, stimulus or regulatory reform?**

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- A bizarre exchange of charges and counter-charges between top US economic officials and their European counterparts has soured preparations for the April 2 G-20 summit in London.
- Essentially, the US wants to strike a deal on coordinated fiscal stimulus to spur demand, while Europeans and some others want to focus on financial regulatory reform.
- After this weekend's preparatory meeting of financial ministers of the G-20 nations, differences over priorities will likely narrow. For one thing, Europe will not be able to brush off suggestions that the severity of its recession, worse than that in the US in several EU countries, may require additional policy measures.
- And all participants will take note that the US is moving ahead fairly quickly in developing detailed proposals for financial regulatory reform that will require international policy harmonization to be effective.

## **Summit planning stung by discord**

The White House National Economic Council chairman Larry Summers issued a strong appeal for Europeans and others to act more forcefully to stimulate domestic demand to combat worsening recessions in the face of a global contraction of trade. Luxembourg's prime minister, on behalf of the euro-area, fired back that Summers' plea was "not to our liking." And the British Cabinet Secretary expressed frustration that it was "unbelievably difficult" to work out summit preparations with the US since "there is nobody there," a reference to the slow staffing of sub-Cabinet level positions in the US Treasury Department and other key agencies. That is indeed a problem, one that even White House counselor Paul Volcker has complained about.

Did Summers deserve the affront? Essentially, he reiterated what is conventional wisdom, with an obvious Keynesian tint, among the vast majority of US economists, whether Democrat or Republican in persuasion. He told the Financial Times: "The right macroeconomic focus for the G20 is on global demand and the world needs more global demand." Treasury Secretary Tim Geithner later offered 2% of GDP as a "reasonable benchmark" for yearly stimulus by G-20 countries in 2009-10. The notion that Europe, Japan, and China can rely on a rapid rebound of US imports, which have been falling for several months, would be rejected, not only at the Obama White House, but in virtually every economics department in the country. The European view that member governments "have done enough" to combat recession is not widely shared in the US among professional economists, either inside or outside the US government. The press spokesman for President Obama issued a conciliatory statement to the effect that "our efforts at the G20 in London will focus on a number of subjects, both financial regulation and economic stimulus, largely because there isn't one single solution to those problems." The effort to turn down the volume on a potentially fractious debate over formal commitments for fiscal stimulus will probably succeed. Thus, the summit will discuss matters in general terms, rather than in prescribing specific courses of action.

## **Bernanke's views on regulatory reform**

What should be clear to the other 19 participants at the G-20 summit is that US financial officials have given a tremendous amount of time and attention to the issue of financial regulatory reform. Fed Chairman Ben addressed the subject in considerable detail in a widely reported speech to the Council on Foreign Relations in Washington this past Tuesday. Not everything he said was new but enough showed the evolution of his thinking about four key issues.

*First, too big to fail.* This is an extremely touchy subject for officials to discuss because they don't want to tell the markets and the public who is and who isn't for fear of putting those designated "too big to fail" at a competitive advantage against other, often more conservatively run institutions. Bernanke himself noted that those who are designated "too big to fail" may take greater risks, while to others it can provide an "artificial incentive to grow" in order to move from expendable to too big to fail. But he conceded that in the current crisis, "government assistance to avoid the failures of major financial institutions has been necessary" and the Fed and Treasury commitment to avoiding failures remains firm. Once the crisis atmosphere lifts, however, supervisory and regulatory attitudes will have to toughen up. Supervisors will need to "move vigorously" to identify management weaknesses over capital adequacy, liquidity and, especially, risk. Any firm posing a systemic risk would receive exceptional scrutiny over risk-taking and risk management. Consolidated supervision of systemically important firms is necessary, too. Supervisors need the authority to inspect all parts of the organization, presumably including off-balance sheet entities and not just the holding company. Once the crisis passes, US financial authorities will need "improved tools to allow orderly resolution of a systemically important non-bank financial firm." In a world that has witnessed the collapse of AIG, that means the Fed and other regulators will go well beyond traditional institutional distinctions.

*Second, strengthening financial infrastructure.* Bernanke mainly repeated familiar themes that he and Geithner, while NY Fed president and presently, have been stressing. That includes a central clearing system for credit default swaps and eventually for over-the-counter derivatives. But the new emphasis in the speech was on what to do to put the money market mutual funds on a sounder basis. Last fall one prominent mutual fund "broke the buck." That meant they were unable to maintain a net asset value of USD1 per share. Huge outflows from money funds took place in a matter of days, mostly from institutional funds, rather than those mainly targeted to retail investors. The run continued until the Treasury provided guarantees and the Fed supported money fund liquidity. Money funds are essential to the US financial system, because they are one of the principal buyers of commercial paper. Various approaches are being considered at the Fed and Treasury for a longer-term fix, but nothing has been decided.

*Third, pro-cyclicality in the regulatory system.* When bank examiners seek bigger reserves against non-performing loans in an economic recession or capital adequacy rules demand higher levels of capital when charge-offs rise, prudential supervision can worsen the economic and financial problems they are meant to alleviate. Bernanke wants to assemble all elements that currently give rise to such pro-cyclicality and take steps to mitigate their adverse effects. This is not likely to be controversial during an economic downturn. But convincing banks (not to mention their accountants) that they should acquiesce to higher levels of capital and loan-loss provisions when the economy is booming and non-performing loans are down is no easy task.

*Fourth, systemic risk authority.* Nearly everybody in the US criticizes the fractured and often dysfunctional financial regulatory structure which is almost entirely based on the safety and soundness of individual institutions rather than the stability of the system taken as a whole. Somebody ought to be in charge of that, members of Congress often demand. But who? Bernanke carefully laid out what such a systemic overseer would need to do and what powers it would need to have to get the information required to do the job competently. Part of the challenge would be access to information and analysis of regulators in other countries, adding to the complexity of the mandate. Bernanke does not come right out and volunteer the Fed for the role. He merely reminds everyone that "effectively identifying and addressing systemic risks would seem to require the involvement of the Federal Reserve in some capacity, if not in the lead role." Congressman Barney Frank, chairman of the House Financial Services Committee, seems to agree. But can they convince those who feel it has done a bad job regulating bank holding companies during the housing bubble and in anticipating the strains in the markets caused by the collapse of the subprime mortgage debacle? That is to be seen.

## **What other bank regulators emphasize**

Outside observers of the US financial regulatory system naturally focus on the Federal Reserve and the US Treasury, in which bank and thrift regulators OCC (Office of the Comptroller of the Currency) and OTS

(Office of Thrift Supervision) reside. But other institutions have enormous power, especially the independent agencies that are not under the control of the White House or the Treasury. The Securities and Exchange Commission, SEC, and the Federal Deposit Insurance Corporation, FDIC, are the most prominent. Finally, state-level regulatory agencies also wield considerable influence and power, especially the New York State Banking Commissioner.

Senior officials of the FDIC, the OCC, and the NY State Banking Commission recently met in Washington with representatives of international banks operating in the US. Their comments provide further insight from their perspectives on the prospects for and obstacles to regulatory reform. Here are some of the main themes:

Sheila Bair, Chairman FDIC: Bair is highly respected for her creative response to the resolution of some “not too big to fail” institutions caught up in the subprime mortgage crisis, notably IndyMac. But she has strong views on other topics. She stressed two, in particular: Basel II and cross-border resolutions of failing banks. On Basel II, she was critical of the so-called “advanced” risk measurement approach that appears to end up with lower risk-weighted assets and thus lower capital ratios at the height of a global banking crisis. “Imagine the leverage it would encourage during good times.” Her conclusion: “I strongly believe that global leverage requirements are sorely needed” for all systemically important firms (echoing Bernanke’s inclusiveness).

Cross border resolutions are another problem. What do you do when more than one country is regulating pieces of a failing institution? Bair chairs a Basel Committee task force on the topic. What they have learned is resolving a failure of any complex financial institution that does business in several countries would be a nightmare. Her policy proposals will keep the financial and legal officials of many governments busy for a long time.

John Dugan, Comptroller of the Currency. He has a simple message for bankers, accountants, and tax lawyers. The current crisis would be less daunting if there were fewer obstacles in the way of encouraging banks to build up larger loan loss provisions during the good times, so that they would not be faced with such enormous capital adequacy problems at times like these. He presented simple, useful, and easily implemented ideas which are unfortunately not always everyone’s highest priority.

Richard Neiman, NY State Banking Commissioner. In addition to his main duties of overseeing state-chartered banks as well as branches of foreign banks operating in the state, Neiman is one of five members of the Congressional Oversight Panel that is evaluating the implementation of the Paulson Treasury’s Troubled Assets Relief Program, the TARP. (The Obama administration will carry on the program but has given it another name, the Financial Stability Plan.) Part of their mandate is to brief the US Congress on regulatory reform. The panel (which includes three Democrats and two Republicans) has identified eight problem areas that may require Congressional involvement: 1. identifying and regulating systemic risk; 2. limiting excess leverage; 3. modernizing supervision of the shadow banking system; 4. creating a new system for regulating consumer credit products; 5. creating executive pay structures that discourage excessive risk-taking; 6. reforming the credit rating system; 7. establishing greater coordination among global financial regulators; 8. taking steps to plan in advance for the next crisis.

This menu is in several respects more comprehensive than the priorities Bernanke, Geithner and the bank regulators have emphasized. All topics promise to be controversial. Several were high up on the list during Obama’s election campaign, notably consumer protection, but not high on the list of his own administration. What the other leaders gathered at the G-20 meeting in London next month may take from Neiman’s list is that the subject of financial regulatory reform cannot be solved at the top. It took years of discussions, working groups and analytical studies to produce Basel II, even longer than the initial Basel I effort. Comprehensive, globally coordinated financial regulatory reform may take longer. It’s worth doing, but it is not a substitute for astute management of a worsening global recession.

## Market skepticism tamed by a rally

A few weeks ago Treasury Secretary Geithner experienced a “baptism of fire” when his outline of the new administration’s policy framework for dealing with the financial crisis was greeted scornfully. As measured by the index of large bank stocks, equity values plunged more than 15% in the next four weeks. Some troubled institutions suffered far greater losses. Clearly the mood in the markets has changed dramatically in the past several days. Geithner’s interview with celebrity TV moderator Charlie Rose this week was greeted with applause, not least because it came on the same day when the S&P jumped 6.5% -- and a few beaten-down financial stocks went up as much as 35% (though they are still down more than 90% over the past twelve months).

Geithner hasn’t deviated much from the original plan, nor has he provided the long-sought “implementation details” market participants say they were demanding. Yet to come is the “term sheet”, if you will, on the Public-Private Investment Partnership proposal, PPIP, that was especially ridiculed when it was first mentioned. But Geithner did let out that the Treasury and Fed would stand ready to provide limited financing for private investors, including hedge funds and private equity firms, but presumably insurance companies and other traditional investors in fixed-income securities. Geithner did not adequately explain why financing purchases of assets is necessary. But market professionals know that leveraged purchases offer hedge funds and others potential rates of return high enough to warrant taking the risk that toxic assets keep falling in value even after the sale. Banks holding toxic assets such as collateralized debt obligations, CDOs, would be encouraged to offer these securities for sale by a Treasury pledge to inject sufficient capital to offset realized losses – and thus insulate the banks’ balance-sheet and capital positions from the adverse consequences. What if the banks don’t want to play this game? asked Charlie Rose. Replied Geithner: “Some will want to do that, but we’re going to try to make it compelling to them to clean up their balance sheets and put themselves in the position where it’s going to be easier for them in the future to raise private capital.” That means troubled banks will have to be prepared to raise capital in the marketplace a lot sooner, and probably on more adverse terms, than if they participate in the scheme.

## Regulatory reform at the summit: what President Obama will propose

Geithner took the opportunity to lay out the broad outlines of the message on financial regulatory reform that President Obama intends to convey to the other leaders at the G-20 summit. The Treasury Secretary stressed that Obama had the leadership of Congress at the White House two weeks ago to start a process of “building consensus on a reform.” As he put it: “you’re going to find us very aggressive and creative and ambitious in the scope of change we’re going to try to bring about.” The focus will be on systemically important firms, whether banks or other kinds of financial institutions. The Obama administration is seeking a “common set of rules of the game that are applied more evenly across all those critical institutions.” What is clear is that the US position will not be, as it has so often in the past, to resist tougher regulatory standards proposed by other countries, but to try to reach agreement, as Geithner put it, on a “race to stronger standards.”

In short, Europeans and others may not like to be lectured on Keynesian demand management, but they have to admit that this administration will take a very different position on the supervision and regulation of financial markets and institutions than anything they have seen in the past decades. Whether banks and shareholders will welcome the change with open arms is another matter entirely.

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