The contrasting worldviews of bank and securities market regulators

Mark J. Flannery

50th Anniversary of the *Journal of Money, Credit and Banking*

European Central Bank March 28-9, 2019

Banks (thrifts, credit unions) are the only firms permitted to sell their debt obligations (deposits – a substantial proportion of total bank funding) to the general public without meeting SEC disclosure requirements.

Why?

Two general types of financial regulators

- Fed, SSM, national European prudential regulators, FSB
  - Protect depositors and financial stability by assuring stable institutions.

- SEC, ESMA, IOSCO
  - Protect investors by complete disclosure of relevant information.
  - Investors can then fend for themselves.
  - No judgment about asset quality.
  - Some limits on what can be sold to less sophisticated investors.

Somewhat Disparate Worldviews

	"Fed"	"SEC"
Consumer protection	Prudential oversight: make deposits very safe, asset restrictions (banks)	Disclosure; few product restrictions
Standard setting	Share best practices	Govern trading conventions
Conduct	Out-sourced to CFPB	Shared with FINRA (an SRO)
Systemic stability	Worry about fire sales	BD oversight largely based on assumed marketability of the firms' assets
Failure resolution	Orderly resolution; supervisory discretion. Firm survival is an important concern.	Net capital rule; bankruptcy courts. Firm survival *per se* not very important.

What financial products are regulated?

1. Liquidity transformation
   a) Banks, D&D
   b) BDs (IBs) fund asset holdings with repo
   c) SPVs and (?) mutual funds

2. Credit risk transformation
   a) Bank portfolios
   b) BDs (IBs) facilitate sale of diversified portfolios – e.g. mutual funds or hedge funds
   c) In the shadows, SPVs finance diversified portfolios with privately-issued liabilities

3. Securities marketing, trading, and underwriting
   a) Banks and IBs have been converging
   b) Fed's oversight of BHCs gives it stronger control than SEC's historical control over BD firms.

Mission Statements

- SEC
  1. Investor protection
  2. Maintain fair and efficient markets
  3. Support access to capital for private firms

- "The SEC is not primarily concerned with ensuring the safety and soundness of the firms it regulates, but rather with "protect[ing] investors, maintain[ing] fair, orderly, and efficient markets, and facilitat[ing] capital formation." (Labonte, 2017)

(Still) More Mission Statements

- International Organization of Securities Commissions (IOSCO)
    1. protecting investors
    2. ensuring that markets are fair, efficient and transparent
    3. <u>reducing systemic risk</u>

- FSB

  “The Financial Stability Board (FSB) will address vulnerabilities affecting financial systems in the interest of global financial stability.” (FSB Charter, 2009)

More Mission Statements

- Fed: “The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.”

- OCC: “Ensuring a Safe and Sound Federal Banking System for All Americans”

- Main bank regulatory tool: prudential inspections.

Who is being protected?

- Bank depositors, who manifest a strong preference for liquidity and certainty of repayment.

- Market investors
  - Often seek risk exposures; preferences not lexicographic on repayment certainty.
  - Registered securities (structured disclosure) for unaccredited (naïve) investors
  - Private securities (no disclosure oversight) for accredited ("fend for themselves") investors, defined in 1982
    - Net Worth (excluding home) of $1 million
    - Annual income > $250k ($300k for couples)
    - 1.2% of US households in 1982; ~ 12% in 2018.
  - Institutional traders, protected via conduct rules like best execution

Changes in the Regulated Institutions

- Banks have become more involved in market activities (securities), particularly after Gramm-Leach-Bliley (1999).

- Broker-dealers
  - initially provided liquidity without risking runs.
  - However, taking illiquid assets onto their balance sheets causes a “multiple equilibrium” problem similar to the banks’.

- Shadow banks provide more liquidity, potentially, than banks <u>OR</u> BDs.
  - Depends on the maturity of (privately issued) liabilities.

Past Clashes

- Example of conflicting incentives/worldviews

- “Over-reserving” for loan losses (SunTrust 1998, others, Wells Fargo 2016)
  - The Fed is happy to have extra loss protection
  - The SEC pushes back against alleged income smoothing.
  - The conflict was finally resolved by Congress, who asked that the SEC consult with bank regulators before doing it again.

Money funds were brought to heel

- Money market funds, 2010,
- Following the Prime Reserve Fund and federal guarantee of MMF balances, SEC reformed money market funds in 2010.
  - Tighter maturity and asset quality restrictions

- 2014: Omit dollar rounding for prime, institutional money funds.
  - Price specified to four decimal places, to reduce incentives to run.
  - Institutions preferred not to deal with the uncertainty (and taxes?)
  - Most institutional funds (and many retail funds) converted to government-bond-only funds.

Pending/future Clashes

- Mutual fund liquidity transformation
- FSB (2019):

  "A key <u>structural vulnerability</u> from asset management activities [is that] … Open-ended funds offer short-term (often daily) liquidity to their investors notwithstanding that the liquidity of fund investments varies across different open-ended funds and also varies over time for any particular fund."

- SEC did impose liquidity requirements in 2016 in the form of disclosure and requiring fund boards to choose an appropriate liquidity policy.

- Failure resolution – SEC has no checkbook

Pending/future Clashes

- SPV liquidity transformation
  - SEC doesn't even know the structure of liabilities (private issues)
  - Not a problem now, apparently, but …
- Disclosures about troubled institutions (vs. secrecy)
  - In order to preserve the opportunity to improve a bank's condition, the Fed is often opposed to disclosing its true condition.
  - Relate to stress test reporting.

Conclusions

- Evolving institutional boundaries ➔ an increasing number of common problems are being dealt with differently (Goodhart's "boundary" problem.).

- Disclosure's effectiveness
  - relies heavily on market efficiency (prices reflect information, markets always clear quickly)
  - May be less applicable to BDs holding assets that lack perfect liquidity.

- Increased success of privately-financed SPVs makes it hard to track liquidity transformation and shocks that may derive from it.

- SEC's net capital rule does not recognize the systemic implications of BDs holding illiquid assets
  - For the largest BDs, under Fed-supervised BHCs, this may be irrelevant. (SEC loses.)