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Bank Regulation and Corporate Finance:
Challenges for the Future
Panel on the Political Economy of Competition
Policy and Bank Regulation

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MEMBERS OF THE PANEL

Gerard Caprio, Moderator
Williams College

Arnoud Boot
University of Amsterdam

Charles Calomiris
Columbia University

Ed Kane
Boston College

Eric Rosengren
Federal Reserve Bank of Boston

Gary Stern
Federal Reserve Bank of Minneapolis

P R O C E E D I N G S

MR. CAPRIO: We've got an excellent panel and an excellent set of issues. Let me outline first the issues that we're going to address in the order that we're going to consider them in and then some of the ground rules. The good news is we've plenty of time for discussion, and so we're going to try to use that time productively.

I'm going to ask--actually, the organizers, who I would like to thank, have already asked Gary Stern to, in his comments, to address the issue of the move towards mergers in very large banks. We now have seven banks with over a trillion-dollar-sized balance sheets. So, the question is, are these mega-banks too big to fail? Sounds strangely like the title of a book that he authored. Should they be cut down to size? Is that impossible or not even desirable?

Secondly, Eric Rosengren's question follows on that, and that is that, given the trend to mega-banks, how can competition be ensured or even increased, and how much should we be worried about these mega-banks?

Thirdly, then we'll turn to Arnoud Boot, and he has been asked or it's been said that some have noted a possible

trade-off between stability and competition. How much is this a concern?

We're then going to turn to Charlie Calomiris, who has a very short question: What's the biggest danger of Basel II? Since the other speakers have five minutes, I guess Charlie only needs about a minute on that one.

And then, lastly, a very narrow question for Ed Kane: What do we know now that we really need to know to form sound bank regulatory policies? And I have to add that Ed is not going to be allowed to quote from Donald Rumsfeld on known knows, et cetera.

Now, here are the ground rules: Each speaker will have five minutes for their opening comments. I'm then going to throw that specific question open to the other members of the panel for their views, and then, depending on how the discussion goes, at that time to the floor, and then at the end of the panel discussion, certainly there will be time for everybody in the room as well to get in. So, hopefully, the audience will have these two segments of time to voice their questions and concerns.

I guess I have to follow the tradition here of

minimalist introductions, but I think it's well known, Gary Stern is the president of the Federal Reserve Bank of Minneapolis and well-known on the issue of too big to fail. Gary.

MR. STERN: Thank you, Jerry. I appreciate the opportunity to participate at this conference, and I will of course give you the usual Federal Reserve disclaimer that I'm speaking only for myself and not for others in the system.

The two questions were posed to me, one having--the first one I take, are the largest banks perceived as being too big to fail? And I took "perceive" to mean a combination of sort of my views as well as how are they viewed in the marketplace to the extent that we can discern that. And let me say that much of what I'm going to be saying is extracted from a book I co-authored, called Too Big to Fail: The Hazards of Bank Bail-outs, and I urge you to pick up a copy at your convenience. So, measuring and demonstrating the implied guarantee for banks, particularly when banking and economic conditions are sound as they are today, is difficult in a single country, much less across

countries. The most recent academic work that I've seen for the United States suggests that, while creditors of the largest banks do not infer an existence of 100 percent implied guarantee as they might have in the immediate wake of the rescue of Continental Illinois back in 1984, these creditors do seem to expect some level of government support.

And I find that analysis convincing in part because the trend in many factors that lead creditors to infer too-big-to-fail status, at least in the U.S., makes me think that status has become more well grounded over time. What I am thinking about in particular are the size and scope of the institutions on the list, the complexity of their activities, and the concentration of the activities in some select markets such as payments processing. And, again, at least some academic observers agree with that assessment.

I think the academic work is important and should be encouraged, but I also take quite seriously the revealed preferences of decision-makers who approve and/or reject a bail-out and of credit market participants. Three such signals from these groups make me think that the too-big-to-

fail designation is alive and well for large, complex banks.

First, relative to its developed country peers, the U.S. seems to have the most restrained propensity to socialize private firm losses. Despite these good intentions, the U.S. may not have the infrastructure required to avoid bail-outs. The FDIC has indicated, in a proposed rule, that it cannot easily distinguish between insured and uninsured deposits, and is not sure, depending on the complexity of the bank's IT systems, that it can provide liquidity to the insured creditors of a failed large bank without bailing out the uninsured as well.

Second, as you know, some of the credit rating agencies explicitly seek to measure the likelihood that a bank will receive external support. That support may come from the government, or it may come from a higher tier, like the holding company. An admittedly cursory look at Fitch's recent support ratings for large banks in Japan, the continent, and to a lesser extent Great Britain, suggests a continuing belief that governments will step in and protect large bank creditors. That is, support ratings for what appear to be the top-tier institutions are 1, the highest

support rating attainable.

More generally, when discussing the historical bank failure record, rating agencies point to the pervasive extent of government bail-outs. And let me just quickly quote from a report from Moody's. The quote is: "No major bank in a developed country has ever been allowed to default on any rated or unrated deposit or debt. The reason, of course, is the official support popularly known as 'too big to fail.'"

Third, over the last five to ten years, there has been a renaissance, shall we say, in central bank interest in financial stability. This renewed interest may reflect an underlying concern about the spill-over or contagion effects of financial problems and the view that the central bank should prevent or address such problems. These concerns are not new, but I take the increased resources devoted to them to reflect either a growing concern about stability and/or about the central bank's ability to make good on expectations that they limit contagion effects. Either development, absent a fairly explicit policy directive to reduce too-big-to-fail expectations, would increase pressure

to provide bail-outs to help stop the spread of a crisis.

The second question: Should we address too-big-to-fail banks by forcing them to shrink? I don't think downsizing our institutions is the appropriate response, at least at this point, because it is either not credible or not necessary.

Credible plans to address too-big-to-fail must address the reasons why governments provide support in the first place. In the book, we identify several general reasons why governments provide such bail-outs. First, they do so to limit the contagion effects on other financial institutions and the economy more broadly. Second, they may provide bail-outs to continue government allocation of credit programs where that is common practice. Third, they may do so to facilitate schemes that enrich policy-makers and their cronies where that happens.

In the latter two cases, I don't think a strategy of downsizing is credible because I can't see a government that allocates credit or is corrupt agreeing to downsize large banks in any meaningful way. Put another way, the problem in these situations is not too-big-to-fail per se, but other

features of the regime, and you need to address those other features.

In the case where the primary motivation for too-big-to-fail status is a desire to limit spill-overs, the credible plan is to give policy-makers more confidence that they understand the spill-over potentials, the contagion potentials, so that they don't overreact in situations, and to take steps to make the contagion effects less likely to occur and/or less costly.

I think there are a number of steps that can be taken to achieve these goals, and, indeed, when it comes to payment systems, a fair amount of work already has been done. Another recent example of a useful step in this direction is the progress in the U.S. in creating an institution that can back up the two large banks that dominate transactions processing in the government securities market, the so-called New Bank Proposal. Until governments exploit these other alternatives available to limit spill-overs and explicitly make such efforts public, I would be loath to even consider breaking up large banks.

In sum, I think if we're serious about trying to

address the situation bank regulators and supervisors find themselves in with regard to some of these institutions-- that is, concern about contagion effects and limited knowledge about the specifics in the situation--there are several things that we should think about doing.

One is that banking regulators should engage in, and to some extent publicize, planning exercises which simulate a large bank failure and the possible responses to it.

The second way to reduce the failure spill-overs associated with failure is to reduce the cost associated with failure, and some steps have been taken in that regard, but for the most part, I think they're untested.

And, finally, I already referred to payment system exposures and things that have been and might be done there.

The point of these reforms--really two points to these reforms: to make policy-makers more confident that potential spill-overs associated with a failure of a systemically important banking organization can be contained, and to make uninsured creditors aware that their expectations about protection should, in fact, diminish.

MR. CAPRIO: Gary, thank you very much. So, first I'll

ask panel members if there are any comments or follow-ups on those remarks. Eric.

MR. ROSENGREN: I'd just add two possible questions to the question that Gary had, and that is, rather than too-big-to-fail, do we have institutions that are too big to save? By that I mean, if you're Switzerland or if you're the Netherlands, since we have someone from the Netherlands here, and you have an institution that's a trillion dollars, and in another four or five years, we may have institutions that are 3, 4, or 5 trillion dollars, will some of these governments have the capacity, even if they wanted to, to do very much to take care of the problem?

And then the second question is do we really have--a lot of the too-big-to-fail literature is assuming that organizations are not global. And we have national infrastructures for banking, but we don't have international infrastructures, particularly--I mean we're getting it on Basel for the regulation, but we're not getting it on the supervision. And by that I mean the lender of last resort is domestic; it's not international. The bankruptcy codes that apply would be done nationally, not internationally.

Deposit insurance is normally just insuring domestic deposits in most countries, if they have deposit insurance. And it's also one of the main ways that we deal with a problem institution is to find someone to acquire them. If they're multiple trillion dollars, there are not going to be very many bidders. So, in the international context, does that change the way you think of some of the too-big-to-fail literature?

MR. CAPRIO: Anyone else? Charlie?

MR. CALOMIRIS: Gary, when you were talking about the FDIC statement that it admits that it can't distinguish the insured from the uninsured, I wasn't sure whether in your book, because I haven't read it yet, you talk about the FDIC's proposal, which seems to me to be very much along the lines of the kinds of things that you would want to advocate, and I just want to mention it and express my support for it.

Their proposal is that, if you can know in advance for every bank what deposits are insured and what are not insured, which is not a trivial task, then at the time that a bank gets into trouble, you could then already have in

mind a segmentation of assets and liabilities so that you wouldn't find people able to use the excuse of the need to maintain liquidity of the deposits as a way to provide a wholesale bail-out. And I just want to point out I think that's one of the examples of things that are exactly along the lines you're talking about.

MR. KANE: You know that New Zealand has worked out and experimented with a protocol and information system that would allow them to come in and, in one day, accomplish what they call a "depositor recapitalization." Although that country does not offer explicit deposit insurance, officials recognize that in a systemically important failure they would cover some small accounts. So, they are working on a plan that would maintain the liquidity of small accounts and then hair-cut the other depositors.

I think that such a plan would be an ideal protocol for us to try to develop for the United States. I would also urge that whatever protocol we develop be rehearsed regularly in fire drills. Only a few incumbent supervisors today have lived through a crisis. So we need to preserve and implant institutional memory about how different a

crisis environment is from ordinary situations.

If it was up to me, I would also insist that supervisory agencies be required to estimate the size of the safety-net subsidies imbedded in the accounts of individual institutions they supervise, especially the largest ones. This could be done using models of option pricing as a starting point. No one can size the costs of the too-big-to-fail-and-unwind problem today. Publishing such figures would create urgency or immediacy to the problem. Public-policy economists can write about the seriousness of the issue as much as we want, but without numbers people laugh us off.

MR. BOOT: Just one very brief comment, because we're going to have much more discussions on these issues. The type of solutions being proposed basically mean that we are segmenting, or compartmentalizing, putting the banks in different pieces, more or less. So, the question--because then we can basically have the problem be limited to this one area of the bank.

So, the big question is, and that question, Gary, also goes to you, is this whole notion of banks providing liquidity and liquidity transformation? Liquidity

transformation, the whole idea of liquidity transformation is that you do not segment the bank. And all these segmentations, where basically liquid assets are being used to support liquid deposits, basically goes to the issue that we no longer really need this or need much less this liquidity creation role of national institutions, and therefore we can segment the bank today, while we were not able to do it in the past. Would you support that issue, that point of view?

MR. CAPRIO: Gary, there are enough questions there to warrant another conference.

MR. STERN: Right.

MR. CAPRIO: But why don't you respond to the ones that strike you as most urgent, in just a couple minutes.

MR. STERN: Okay. Well, let me just respond very quickly. First of all, I agree with Ed Kane and alluded to it very quickly in my comments that I think it would be valuable both to run some simulations and to publicize those results. You want to publicize the results because you want to get the attention of the creditors.

As far as the FDIC proposal, Charlie, no, that wasn't

in the book because that came out after we wrote it. I do think that's a good proposal. They've gotten push-back from the banks, as you probably know, because the banks argue it's costly, among other things. Of course, it's costly. That doesn't mean it shouldn't be done.

The question about the magnitude of these banks and whether some country had the resources and whether--and what kind of cooperation might be required internationally given the scope of some of these institutions, I don't have anything novel to say about that, I mean that's the heart of the problem in some sense. And, you know, would Switzerland or the Dutch not find the resources if required? I don't know. You know, presumably, they have the printing press and they've got--well, at least the Swiss do. [Laughter] And they have taxing authority and so forth.

You know, your point, Arnoud, I guess I haven't thought about it that way. My principal--if I were the czar of this, what I would want to try to do is change incentives. I wouldn't be so worried about trying to segment things. I think what we really want to do is change incentives here. Can we sort of take too-big-to-fail off the table entirely?

I don't think so. I don't think that's credible. But can we change the incentives so that the system works better and the probabilities decline? I think the answer to that is yes.

MR. CAPRIO: The question I was going to ask is, can we at least avoid making too-big-to-fail worse? But I think we'll have time for that in the ensuing discussion. So, now I'd like to turn to Eric, who's going to talk about the trend to mega-banks and what we can do about increasing competition. Eric?

MR. ROSENGREN: Yeah. I didn't actually see mega-banks as actually, in most cases, having much impact on competition. And when we think in the United States, and I'll take New England as an example, we have two very large banks that are retail banks. One is Bank of America and the other is Citizens, which is owned by the Royal Bank of Scotland. Now, what's noteworthy is that J.P. Morgan/Chase, which is in New York, doesn't have very many activities in New England, and neither does Citigroup. They're both trillion-dollar banks, but they still don't have a national franchise. So, arguably, we only have one bank right now in

the United States that truly has a national franchise. That would be Bank of America.

So, when I talk to the small banks in my district and asked them what worries them, and they are pretty vocal about competition concerns, I never hear them mention Bank of America or Royal Bank of Scotland.

The very first one that they will mention are credit unions. If you want to have a very long discussion with a banker that you want to escape, just ask them about credit unions, because that's the first thing that will really get their ire and they'll go on and on about it. The second one they'd mention was Fidelity. It's New England, but you can have a checking account out of Fidelity and the rates are quite competitive. And the third is ING Bank, and what's interesting about ING Bank is that it's an Internet bank.

And increasingly you're finding Internet banks posting very high returns on CDs, and if you're in Aroostook County, Maine, where you're used to being geographically separated from other markets and being able to exploit the fact that you can have very low rates on core deposits, that's being eroded away as people have a greater comfort level in

actually putting their funds in something like an Internet bank.

So, when we normally think about competition, we do competition analysis in the United States, the first thing you have to do is analyze the market, and that's both thinking about the product and thinking about the geography.

And I'd argue that, in many respects, both the assets and liabilities side of banks is getting far more competitive despite the mega-mergers. So, we look at Herfindahl indexes for deposits, but, for example, MNDA accounts at Fidelity aren't included in those, frequently credit unions aren't included in those, and when we have a competitive problem, it normally is in a very small county somewhere that's rural. It's not in a major city, and it frequently doesn't involve the largest banks, because the market there has been defined as being fairly narrow.

So, if you're thinking about banking as, well, it's deposit accounts and you either bank at home or you bank at work, that's kind of the logic that our competition laws in the United States have been founded on, but I think the technology is changing fast enough that it is questionable

how much longer you can argue that that really is the market for a lot of banking products. And I think the same thing is true on the loan side, the asset side of the balance sheet, as well, that there are a variety of players that are not necessarily regulated by a bank regulator that provide loans, and increasingly there's a lot of competition on that side of the balance sheet as well.

So, if I was worried about competition, I don't think I'd be looking at the mega-banks in terms of their retail operations. I wouldn't be focused on deposits, but at, actually, some of the things that Gary talked about in terms of the infrastructure that some banks provide. So, when we think of processing banks, for a lot of the activities and processing, there aren't that many providers of many of the processing activities. In some instances, there is only one or two providing processing activities. Some of the dealers in derivatives markets, some of the securities lending operations, there's a lot of financial infrastructure where there are relatively few players, and that's where I would think that potentially you could have issues with competition, but it wouldn't be so much a concern that you

have a trillion-dollar bank buying another bank somewhere in the United States or somewhere else in the world. I guess that is an area of competition that I am not nearly as concerned about.

MR. CAPRIO: Thank you. Ed?

MR. KANE: In my own work, I assess the competitiveness of any market by means of the contestability model. This model says that what matters is not the number of competitors, but the entry and exit costs competitors must bear. In U.S. banking, the exit cost that mattered most came from deposit insurance. Capital forbearance kept banks from being forced to exit when they were in deep trouble. Ready regulatory assistance reduced entry because a properly capitalized new institution couldn't expect to come in and take away the market.

I think it's interesting to look at how hard the banking industry is trying today to keep Wal-Mart out of the banking business. The regulatory barriers Wal-Mart has encountered are entry costs. Bank lobbying pressure is trying to keep commercial firms out of banking activities as long as they can.

Entry from credit unions can illustrate the idea of regulatory competition. The North Carolina State Employees credit union is now the second-biggest credit union in the country. Over time, its initially restrictive "common bond" seems to have been redefined as to live in North Carolina. I suspect there are other loophole-extensions of even that definition. For example, it may be enough to have a relative living in North Carolina --I don't know the end of it. But anyone can see that regulators' willingness to loosen the restraining force of the firm's common bond has put it in a position to operate very much like a bank and to compete on its credit-union platform as hard as it wants. Reduced entry costs are reinforced by improvements in deposit- insurance administration that lower exit costs. The point is that old-fashioned calculations focused on concentration ratios shown by incumbent competitors misconceive where pricing pressure comes from today.

Another place where I see a problem lies in the treatment of small customers of targets in bank mergers and acquisitions. Small customers that have ongoing financing needs are likely to find that, if the combination is not a

merger of equals, managers of the acquirer will dump loan officers from the target in wholesale fashion. The result is that the intangible informational capital that's been built up at their bank by small customers is in danger of being lost. A concern for the evaporation of this capital needs to be built into merger evaluations.

MR. CAPRIO: So, this means since I once vacationed on the Outer Banks I'm eligible? [Laughter]

MR. BOOT: Let me elaborate on that point. The competitive concern from having very large institutions, I think if I look at many of the European countries, comes from the lobbying power that large institutions have over the regulator, basically, or the government, one of the two or both in general. So, large institutions, and actually there's a whole body of research that shows that and that comes back to Ed's point about entry in the market, and a whole body of research that shows that bank-dominated system, institutionally dominated system, are very bad at allowing for entry.

Now you can say, indeed, interbank competition and the possibilities of entering the market have gone up, but these

have been in highly focused activities. So, these--your Fidelity example is a very focused player. ING Direct is an extremely focused player. So, depending on the activity we're looking at, this contestability is there today, and in all kinds of areas there is no contestability yet.

And the regulatory point may be one more added dimension to it. I see in many European countries that even these focused players that only do one activity, they still have a very hard time of getting in, and sometimes it has to do with the fact that the regulator imposes the full system, the full mechanism, of regulating the bank on that same bank while it is a very focused player. So, the regulatory mechanism is aimed at a very broad player and it is applied to a very focused player, and the focused player has to meet the same type of requirements as this broad player.

So, these implicit barriers that large institutions bring I'm most concerned about.

MR. CAPRIO: Charlie? You're on.

MR. CALOMIRIS: So, I guess I just want to make what I guess is a very obvious point, but I think it's an important one, and that is that banks really are operating in many

different markets, and, as you pointed out, ING can compete for some customers in some markets that the bank is appealing to and not so much in others.

So, since you mentioned New England, you know, in a paper I did recently, I argued that the place where the merger of Fleet and Bank Boston was most destructive to competition in New England was in the middle-market lending area because location matters for middle-market borrowers and there wasn't really a viable competitor for middle-sized middle-market borrowers. That is, small banks can't make middle-market loans--they're too small--and big banks who don't operate in New England are at an informational disadvantage. Interestingly, Sapienza, in a previous paper looking at Italy, had found a similar result, which is that in some of these niches for borrowing, that location matters more than others, and size, of course, matters.

So, my question is--because you mentioned about Citizens coming in, which of course was subsequent to that merger--and what I'm curious about is whether Citizens has come in and made a big play in middle-market lending because that would be an indication that maybe there was a big

incentive coming from what I estimated to be a full percentage point increase in spreads as to that class of borrowers as a result of the merger.

MR. STERN: Let me just, since we all seem to be weighing in [Laughter] and since I have a couple questions too, I mean my perception, in many cases, would be we have more rather than less competition. It's true that Citi Corp. and Chase don't operate physically in New England. You could certainly run around with all the credit cards from those companies that you want, and, you know, I think from the customer's point of view or the point of view of many customers, shall we say, there's ample competition in many markets and in many products. That's my perception.

What I find a little more interesting on the competitive front, but it doesn't pertain directly to traditional commercial banks, is the persistently high fees that mutual funds seem to be able to collect and the amazing earnings of some of the large investment banks. In the latter case, I suspect part of the answer must be risk. In the former case, I'm not sure what has succeeded in keeping those fees as high as they are.

MR. CAPRIO: I should have forecast that our panelists would have a lot of feedback for one another. [Laughter] So, why don't we adopt the policy that if you have a comment that is urgent, that would fit in at this time rather than the discussion at the end, that you raise two hands [Laughter] so that I know that it's really pressing. And while you're thinking about that, I'll let Eric--

MR. ROSENGREN: I'll just respond very quickly. When there are large acquisitions, you frequently find de novo entry. So, it is saying that, getting to Ed's point, that as soon as you see a merger between two very large organizations, there tends to be a whole slew of de novos in that region saying they're not all that worried about being able to compete and, in effect, they're worried that the large bank won't be serving all the needs of the community that was being served before by the other two.

So, I think that is an interesting observation. Now, that may not be true in every country, how easy it is to have de novo entry, but in the United States it is relatively easy. I think the political economy question for barriers to entry is an interesting one. I'm not so sure,

in the United States' context, it's as big a deal. In some respects, I'd say the community bankers and the credit unions may have a more powerful lobbying than the largest banks, but that could be different across other countries as well. I completely acknowledge that there is the potential that the political economy could create competitive distortions that you wouldn't want to see.

In terms of Charlie's response, actually, Citizens-- that is the sweet spot for Citizens, and TD Banknorth--we did get some entry by a couple of other players, and the middle market is exactly what they're focused on, but the middle market's getting smaller and smaller. There are banks that are willing to go anywhere in the country for pretty small loans now. So, I'd say that was more of a problem five or ten years ago. I think it's becoming less of a problem, but I think you're right that it is something certainly to observe.

And Gary's point that it is product by product is definitely true, that you can't think of banks as doing one thing or two things. They're an amalgam of a lot of different activities. They organize themselves along those

various activities. And when we do the competitive analysis, we tend not to look at all those activities. We tend to be more focused on the liability side. So, as Ed pointed out, that probably is ripe for being revisited at some point in the future.

MR. CAPRIO: Okay. Seeing no two-handed interventions, now we'll turn to Arnoud, who's going to talk to us about possible trade-offs between stability and competition.

MR. BOOT: The--actually, the question is whether the possible trade-off between stability and competition is a concern? The problem with that question is that we have no understanding, or no good understanding, of whether there is a trade-off and how that trade-off looks, let alone to answer the question whether that trade-off is a concern. Since we don't know it, you may say, since we don't know, it should be a very big concern. [Laughter] So, I would tend to answer, give an answer yes to that question.

Actually, the concern goes much broader. The concern is, having been at least in two smaller countries in this debate as more or less a central bank representative, central banks have been using the concern about stability to

prevent competition from coming up. So, for central banks-- and this is a perfect red flag. As a central banker in any European country, if you put this up, then everybody listens and nobody dares to say the opposite, and no politician dares to say the opposite, because even this very small probability the central bank might be right, the politician would lose his or her job if a bank goes down, and the central bank could say, "See? We told you so."

So, this red flag has enormous power. Actually, I would not use that power too much against Italy because Fazio, a former central bank president, was mentioned. I think Italy--there's a much fairer point of view with respect

Actually, many of these things are much more transparent in Italy. Italy is amazingly transparent by putting all the corruption on the table. [Laughter] So, I think that should be, we should be positive about that.

The second is that most other countries in Europe had done the domestic consolidation before the anti-trust authorities really got power. Meaning, in the Netherlands, for example, anti-trust authority in banking was with the central bank. Up to five years ago, it was just the centra

bank, and obviously the central bank couldn't care less about enforcing anti-trust. So, but what have we seen? We've seen that anti-trust agencies came up, and they are fiercely following these countries and putting enormous pressure on countries like Italy that were relatively late in arranging domestic consolidation.

So, my point of view with respect to Italy, despite the fact that it was the Deutsche Bank that tried to get in, is much more positive. ABN Amro knew that they were at the right time, and they knew that the European Union was at its side and they had a chance of winning. While they would not try to do the same thing in France, because France is much less open, so it would have been much less obvious that the French would be doing something that was not right. So, actually it was the transparency of Italy that allowed ABN Amro from getting in, and they never managed to get into France and they have been trying that for fifteen years.

Okay. Now, why do we not know anything about competition and stability? Why do we know that little? One of the reasons is, as you'll see tomorrow--John Boyd together with his co-authors is presenting this paper about

conflicting theories with respect to this competition/stability trade-off--for a long time, we thought we had some answers that rents in the banking system make banks' response, the community type argument, rents in the banking system would help banks to be safer and therefore there would be a trade-off between competition and stability. More competition would mean less stability.

We're no longer sure, and the point that our paper basically provides one potential story, that rents in the banking system mean that borrowers have to pay higher rates, and once borrowers pay higher rates borrowers become more risky due to moral hazard and adverse selection. And once you have that, actually less competition in the banking system may make the whole system less stable.

Now, you can come up with all kinds of other stories. These are stories which we are not sure about this trade-off. Empirically, again, by some people that are present here, Beck, Demirguc-Kunt and Ross Levine, they have in a paper they show in a more open system--open system truly measured by possibilities of getting into entry barriers--more open system, less entry barriers--they show that these

systems are more stable. So, the general empirical evidence would rather point that competition might be good for stability.

Now, I think--and that will be another paper that will be presented tomorrow, actually a paper by myself together with Matej Marinc, we will present tomorrow. Actually, one of the implications coming out of our analysis is that this whole issue of whether competition is bad for stability, we might need to look at it more dynamically, and "dynamically" meaning that the transition from once you open up in a country, so the transition process towards more competition is the process where, by definition, stability is at stake.

The transition process is the dangerous process. As we show--again, and that supports a little bit Eric's remarks about competition measures--we show that the better banks take advantage and the better systems take advantage of opening up markets so they will get market share at the expense of weaker systems. So, how do the weaker systems respond if they face a loss of market share? That will lead to more risk in those systems. These weak banks will do strange things, and weak systems become less stable. So, it

is transition process which is particularly at risk.

So, that doesn't answer the question yet, how we should look at competition/stability trade-off. It only indicates that that trade-off does exist. The direction of the trade-off, however, could be very different depending on the situation we are looking at.

Now, a little bit in line with the remarks of Gary Stern, what would we do about it? What is this whole concern about stability in banking? Now, I think it's clear from my remarks that I don't believe that regulators should be in the business of limiting competition, and I think that has been a very common theme in every comment we have heard here. I also think it's not sustainable, and it's not sustainable for varied reasons being mentioned before, that we have all kinds of level playing field issues, all kinds of players coming into the banking sector that may not be gold banks, but compete in the sector. So, level playing field issues, regulatory arbitrage issues dictate that we cannot limit competition.

Actually, it's also very dangerous if we would let regulators limit competition because it would be very

discretionary and, given that it's discretionary, all the political economy issues come in, that the large banks will have a hold over the regulator; the insiders will have a hold over the regulator; the outsiders cannot come in because they have no contact with the regulator; et cetera, et cetera. Those issues, indeed, might be more dominant in the European environment.

Finally, what could be done--now, then you get to a few issues. One, learn to deal with the crisis when it comes. Now, the problem is we are concerned about systemic crisis, and that's also a little bit of the problem with the papers being discussed tomorrow. Very often papers talk about an individual bank crisis. So, literally speaking, this Boyd et al. paper is about an individual bank in crisis. We are not concerned about an individual bank; we are concerned about the system being in crisis.

Now, we have very little understanding in today's banking environment where the real systemic risks come from.

They are probably a much more market-based definition of systemic risk. It comes somewhere from the market, and it's going to hit financial institutions in a way we don't know

yet. So, it's kind of hard to exercise. So, we need exercises. We need like we do in Europe because there we have particularly this regulatory problem. Since all regulators and supervisors are local and our banks are not local, at least many banks are not local, we need to do these crisis exercises, and we need to be ultimately prepared.

Now, that also means that proposals which are heavily on the table in Europe and should be on the table, like prompt corrective action, as you have introduced in this country, is absolutely crucial in the European context because once there is a verge of a crisis in Europe, there is no coordination mechanism to resolve the crisis in Europe. So, if prompt correction is needed anywhere, it's needed in Europe.

Indeed, issues of market--this is to bring market discipline into banking--I would be all in favor. I haven't heard yet any proposal that does it in a very serious way. I'm very hesitant to the suggestions that are academic, with respect to subordinated debt, pricing information. Okay, it's going to play some role. It cannot really harm. No,

it cannot harm. Will it really help? I doubt it will really help.

So, in the end, we need to find a way, and that's Gary's final statement as well, to limit the scope of regulation and supervision--to limit the scope, so, meaning limit the systemic concerns in banking so that we are better able to localize these concerns, rather than have the whole system at risk across institutions, across markets, and across borders, because it's very hard for regulators to handle that.

MR. CAPRIO: Thank you. Any comments here on that uncontroversial statement? Besides, I actually have to ask, do you really think that if the commercial banker Fiurini had not been wire-tapped that that ever would have come out?

I find that's hard to believe. That's the only way that investigation came to light, is that Fazio gets on the phone with someone who's being wire-tapped.

MR. BOOT: No, the issue was Italy had created an independent financial market regulator. Italy had created a financial market regulator, an SEC-type regulator, much more vigilant than the other countries', and that regulator went

after the bankers to figure out information. So, indeed, it is always either tax evasion, it's always something that somebody got caught on, but it was this independent regulator that Italy had put in place that basically facilitated opening of the system.

MR. CAPRIO: We'll follow up over dinner. Go ahead, Eric.

MR. ROSENGREN: You had a very tough assignment for a five-minute discussion. Financial stability is a very difficult issue, and when people say "financial stability," people frequently don't mean the same thing, and I think that is a problem with this, the way central banks are looking at it and literature in general.

There seems to be two kinds of things that people tend to be talking about. One is a situation where all the banks take the same type of bet, and the bet goes bad. So, that could be commercial real estate and everybody's in commercial real estate; commercial real estate goes down and all the banks go down together. In that case, you would think that more competition would mean that at least some people wouldn't be in the same position, and that that would

actually be a good thing. There would be some people left standing.

The other kind of financial stability issue would be a situation where it gets at more of a 9/11-type of situation where you have somebody like a large processing bank located in New York; they get hit and there are no close substitutes for them, and as a result, it's very disruptive for a period of time. And how well you can bring that back up has a big impact on what the overall effects are on the financial system. In that case, it really does seem to be a lack of competition that's partly the problem, because if you had other people that could pick up easily what that institution was doing, the systemic concerns, at least for those kind of more operational hits, go away.

So, I was curious which kind of financial stability, or were you using a different definition than either of those two?

MR. KANE: I said earlier that I prefer to use the term "contestability" in place of "competition." The reason is because taxpayers and officials can write a contract on contestability's entailments. Economists can actually define

a metric for measuring both exit costs and entry costs. On the other hand, financial stability is a concept that lacks contractability. We don't have forward-looking operational measures of the current "stability" of most countries' regulatory systems. It has been possible to go back after the fact to size(say) the S&L mess to figure out what price the country paid for forbearance in that era. But to delve into the banking system of a country and come up with forward-looking measures of either regulatory performance or fragility has not been done. I see this as a really important research agenda for making agencies accountable. So, I was thinking, like Eric, I was thinking about commercial real estate too because the last major banking crisis that we had in the U.S. in the late eighties/early nineties was largely focused on that sector. So, at the risk of great over-simplification, what I was thinking about was, so if you had more competition in New England and Texas, places where the crisis was particularly acute, as I recall, presumably more players would have had two effects: There would have been even more commercial real estate loans made because pricing would have been affected, but the

exposure of any given institution may have been smaller. And I don't think you can say a priori. And that maybe is, you know, writ small, that maybe is what Arnoud's talking about. You know, it's very hard to say a priori whether this leads to more or less stability.

MR. ROSENGREN: I guess I would say, thinking about economic history and about comparisons, let's say, between the Canadian and American system historically, or between the California banking system and the rest of the United States historically, that people a hundred years ago and economic historians looking at this would be stunned that anyone thinks that there's a trade-off between competition and stability, since what competition meant was allowing branching, which both reduced overhead for entry and made banking systems more efficient and more diversified both, and also seems to have stabilized the ability of the banking system to react to shocks.

So, I would sort of say that, from a historical standpoint, that this is not an issue. There is no, I think, strong even reason to think that there would be. I can understand that there would be models of this, and I do

understand the Keeley story. I've never taken it seriously because I don't think it was convincing for what it was. So, I just don't think that this issue has as much legs as the theory seems to indicate.

MR. BOOT: Yeah, it's obviously--Charlie's conclusion I would as a steady-state situation get into your direction. And also that's the empirical evidence that I suggested, that open systems that are competitive actually are also the most stable systems because, as cleansing mechanism, institutions are being held sharp, et cetera, et cetera.

It is the changing environment which leads to the problems, and actually every example we have mentioned so far is referring to a situation where things have happily changed. Your real estate example, and your real estate example as well, is a rapidly changing situation.

Sweden got into--one of the few Western countries that in recent decades went a severe systemic crisis, and that's one country where CEOs of banks were very respectable, prudent people. These were not fly-by-night operators in any sense. It was deregulation that allowed them to get much heavily into real estate. That was the initial trigger

mechanism for getting into a crisis. The strange thing was that competition there actually did bring about the crisis, if you want, because there was deregulation of real estate.

The five large banks in consolidated system--the five large banks were mentioned every two months in the newspaper by saying, and this is literally the heading in the newspaper:

"Handelsbanken"--that's one of the five banks and the only bank that survived the crisis basically--"Handelsbanken Loses Its Touch." And what was meant, they didn't go as aggressively in real estate as all the others went. It was the only bank that prudently responded to real estate. And so it was the competitive pressure for market share that led all these other institutions of going like crazy in real estate, but most importantly it was a changing situation. It was deregulation. It was new activity. Sweden didn't have a real estate crisis for eighty years, so there was no memory of a real estate crisis. Real estate loans were safe in the minds of the Swedes.

You have to very quickly say the second because I think your distinction still is extremely valid, that individual, that certain shocks lead to individual problems in banks and

having more banks, assuming that banks do not follow in a herding strategy, and my example was a herding strategy, then having more banks is much better. Having a consolidated system means that that bank may fail with a lower probability, but when it fails, the system is down. And that's basically, that would be my concern too.

So, in that sense, my attitude is that a consolidated system has a lower probability of failure, but when it fails, it's systemic. But maybe you should get into that for a second, because that's a contestability issue, and the contestability issue mentioned by Ed, I think it's an extremely crucial issue. I emphasize "extremely crucial" because the U.S. is so much different from Europe in that respect. Mergers in Europe have not led to new entry. There is no new entry; and in this country, there is new entry. So, contestability is even much more a problem in Europe than it is in the U.S.

MR. CAPRIO: Okay, Arnoud. Thank you very much. We're now going to turn it to Charlie Calomiris, who's going to address the question, what's the biggest danger of Basel II? Charlie, I suspect that when the conference organizers came

up with this question, they were neither referring to the global warming that's associated with the felling of all the trees that went into writing the various reports of the Basel Committee, nor the cholesterol problem of the people meeting in Basel to discuss it so many times. [Laughter] So, maybe you can throw some light.

MR. CALOMIRIS: Well, at least those would have been new things that I might have said, and the real frustration, of course, in trying to do this, especially briefly, is it's hard to, especially to this audience, really say much that's new. So, what I think I'll do is just quickly say what I think is important, and then at the end maybe give my judgment about where it all leads us.

So, I'm going to say something I think is not very controversial and fits in with what people have been saying today, which is that inadequacy of capital, which leads to large taxpayer exposure to big losses, is the biggest risk that's related to the Basel system because the Basel system, in my view, is inadequate as a minimum capital requirement system.

And so, the first thing I want to do before getting

into that is to say why didn't I go in the direction of the Gorton-Winton view of what the big cost or potential risk is, that we might have too much capital. And by requiring too much capital, especially during business cycle downturns, the capital requirement becomes a binding constraint. Banks constrain their credit supply, and you magnify the downturn.

So, I think, to try to be at least a little controversial, I want to talk about why I don't think that that is, from a practical standpoint, the same order of magnitude of concern as the concern about undercapitalization.

The first reason is that, gee, I wish this were a problem. That is, I don't think that the bank capital standards in Basel are binding, and I'll talk about that in a little bit. That is, I think that they are very much open to manipulation and that banks will be able to, under the current system, avoid, let's just say, overcapitalization risk.

Secondly, even if the standards were binding during downturns, I think that we've learned from a lot of research

that many people in this room have done is that it would be unwise to forbear, that is, to relax the standards, during a recession because we really don't have an exploitable policy trade-off that favors such a relaxation. If you actually relax the capital standards, the wrong kind of risks get undertaken by banks that are in bad states of the world, and so we get a very counterproductive further magnification, in fact, of the recession through very bad bank losses.

So, I just want to emphasize for both of those reasons that I expect banks to be able to typically manipulate capital standards to avoid their binding under the Basel standards, and secondly, that I think it would be a bad idea to try to relax them, so I don't worry about the Gorton-Winton risk.

So, now let me talk a little bit about the details of why I think these are manipulatable and what worries me. And I want to emphasize, the mischief of Basel contributing to this risk of inadequate capitalization is different depending on what country you're in. If you're in the United States, the biggest risk is that the effective reduction in the risk-based capital requirement, which the

large banks will be able to show, is going to create enormous political lobbying pressure for getting rid of the leverage requirement. And I'll return to that in a minute.

It will undermine the credibility of the leverage requirement potentially, although that would be very unwise and it would be the wrong way to think about bank capital.

In the G-7 generally, the fact that these standards are going to be so open to manipulation, especially in countries that don't have currently a leverage requirement, means that immediately those banks are going to be able to get to very, very low capital ratios. So, just for those of you who haven't seen the Quantitative Impact Study 4, ten of twenty-six banks in the U.S. would, if it could use the internal models approach, have less than a 2 percent risk-based ratio; twenty of twenty-six would have less than 3 percent.

When you look at the variation that these banks attach to, let's say, a 5:1 ARM with a particular LTV and a particular FICO score, four banks attached less than a 10 percent risk weight to that; two banks attached a 30 percent risk weight; and one bank attached a 75 percent risk weight.

So, what we're seeing is huge variations, and you could

imagine why: Correlation computations could be very different. And so, then the question is, well, can we hold banks accountable for their models? Well, no, because how do you penalize them after the fact? Once you get into the bad state of the world, I think these factors are going to encourage extreme manipulation. So, I think, for large banks that we've been talking about having too-big-to-fail problems, this is a big issue.

I also want to emphasize that what's wrong-headed about the risk-based capital requirement, to begin with, is that we don't really want to be targeting default risk on some kind of instantaneous basis, and this is a point that I think George Pennacchi made many years ago. In fact, George, I think it was in the mid-1980s that you talked about the way that default risks should be thought about, and deposit insurance depended crucially on the intervention rule of the regulatory authority. And the reason that we need to have a large minimum capital ratio in leverage terms is because of the lags in reporting, recognition, and action. And we have to get our mindset back to that kind of analysis.

And then we have to ask ourselves--although I have written quite a bit about why raising capital can be costly--but we have to ask ourselves, does it really hurt our economy so much to require banks to have a 6 percent or 7 percent or even 8 percent equity ratio? Remember, if the equity is raised during good times, it's raised primarily through retained earnings and also through capital offerings that have low transaction costs; during recessions it can be very costly to raise capital, but not during booms. And so, I don't really believe that there's anything like a symmetry between the high cost of not having capital in bad times and the low cost of having to raise it in good times.

So, I think that it would be a very strange system that would be geared toward pushing that capital ratio down to numbers like 2 percent.

In emerging markets, the cost of Basel is a little different. It is the same one, the same undercapitalization risk, but the way it plays out there is that Basel has side-tracked sensible approaches. That is, people were independently, in Chile, in Argentina, in Hong Kong, developing reasonable systems--and I'll say in a minute what

I think that means - but reasonable systems are getting side-tracked because Basel seems to be the international standard, and it's very hard if you're a wise policy reformer in a developing country to convince the politicians in your country that they should do what you're saying, rather than what the great Basel Committee has put together.

And I think there are missed opportunities for reforms in many countries that come from this side-tracking.

So, I would say, although it wasn't a question I was asked, how do we avoid it? I would just say three things:

We need to make the minimum capital requirement, or maximum leverage requirement, a standard, not just for the United States, but for everywhere.

We need to have true market discipline. There's a lot of evidence showing that it matters quite a bit. That's not just disclosure but also discipline through observing market prices on uninsured liabilities of banks. And I want to emphasize what I mean by that because this is sometimes a very difficult topic. What I mean is that we need to have some credibly uninsured debt obligations and that we have to be able to observe their prices, and the main reason we want

that is to make regulators behave appropriately. It's not as is often supposed that we're going to construct an algorithm for a closure rule based on the pricing spread. That's not the point; the point is we want to have the 800-pound gorilla in the room. The way this works in economies that adopt it is that regulators can't pretend that a bank isn't insolvent because all of its uninsured creditors are either running for the exits or they're charging huge interest amounts. And the real issue is the disciplining of the regulators, and that's why you need to have this signal, the canary in the coal mine, as it's sometimes described, not because it's exact or perfect, but because it's an agency discipline.

And I would say, finally, echoing what Arnoud said, early intervention, prompt corrective action has to be part of the capital prudential system too.

So, to me, a maximum leverage requirement, some sort of prompt corrective action, and some kind of credibly uninsured debts so that we can at least see the behavior of the credibly uninsured creditors as a discipline on regulatory behavior, seem to me to be the three crucial

things, all of which are absent in the Basel standards.

MR. CAPRIO: Thank you, Charlie. Comments here? No controversy at all. [Laughter] Eric?

MR. ROSENGREN: We won't have enough time to fully discuss this, but I'll just make a couple of points. One, in terms of the quantitative impact study, none of those banks had any of their models validated, and a lot of the reason that we did the quantitative impact study was to get an idea of what kind of parameters that would come up with and try to provide more clarity. So, I wouldn't use the quantitative impact study to determine how much capital banks under supervision will actually have, and I think it was quite premature to assume that anything that they presented then would be acceptable. And a number of those institutions were voluntary submitters who clearly were not ready to submit very much. They didn't have data systems in place. They had very gross assumptions in order to get it. So, I'd weigh the quantitative impact study with a little trepidation before I put much weight there.

The second is that it's not a question of whether there are some problems with Basel, but does it get us to a better

place than we are now? So, risk sensitivity in capital, you can argue about what the right level is, but saying that institutions that have a lot more risk should hold more capital for that risk seems fairly intuitive to me. Now, you can figure out what's the best way to do that, but I'm not sure the best answer is going to be to have a capital regime that's completely insensitive to the amount of risk that an organization's taking.

And a lot of Basel is not about capital. It's about risk management. And so, one thing to prevent failure is certainly capital, but good risk management also will help prevent failure. And I think that Basel II is doing a very good job of encouraging institutions to develop much better risk management practices. A lot of institutions did not have loss data for operational risk. A lot of institutions did not have historical default data. A lot of institutions had no idea how to come up with a loss given default, even though a probability of default and a loss given default are pretty fundamental to figuring out what's the right price.

So, I think there are a lot of other things that go into the Basel context besides capital. That's important to

keep in mind as well.

MR. CAPRIO: But if I could indulge then, to paraphrase George Kaufman, wouldn't the Basel Committee make a great contribution to the history of regulation by not implementing Basel II? They've already made their contribution by putting more attention on quantitative risk management.

MR. ROSENGREN: Not every institution's at the same point, and one thing that has happened over the last five or six years is risk management has gotten a whole lot more attention and a whole lot more money at institutions than it had before. At institutions that are not planning on being Basel-compliant, they are not spending nearly as much money.

Now, some could argue they're spending too much money on it, but I could argue that some of those institutions that are choosing not to be Basel-compliant don't have the risk management they ought to have in a global context. So....

MR. CAPRIO: Ed, [off microphone].

MR. KANE: My perspective is quite different. First, the Quantitative Impact Study 4 shocked me because it showed the disconnect between the quants in giant banking

institutions and the interests of the institution as a whole vis-à-vis the regulators. To have reported to regulators that they would face such a decline in industry capital seemed to have the goal of telling bank CEOs how good Basel was going to be for them without realizing that this information was bound to scare the regulators. If you don't have proper communications between the quants and the top management in systemically important institutions, the internal-ratings-based approach is very dangerous.

Second, it's lame to ask only whether this approach might get us to a better place than we are now. I would argue that we should reformulate our perspective on Basel to frame it as a process whose current realization might be called merely "Basel (T)." Basel (T) would be an integral from date zero to now of the Basel system at instant t integrated to T . That's what Basel II actually means. Basel is a framework for continual renegotiation. The attempt to finish it, to say, "It's done now. Everyone can safely sign off on it in all countries," is mischievous.

Third, the issue is what large banks really want from Basel. Why do they want capital requirements to be

unrealistically low? I think it is because banks like to be able to advertise that they have vastly more capital than government standards require. That relieves them of pressure to keep their accounts in a transparent way.

I strongly support keeping the simple leverage ratio as a trigger for supervisory intervention. Although more transparent than Basel ratios, this ratio is a lagging indicator of bank fragility. When an institution gets in enough trouble to show 4 or 3 or 2 percent accounting capital, a bank's tangible capital would be long gone. At best, they may have some intangible capital left. Therefore, the put-up-or-shut-up trigger has to set at a substantial positive amount.

Finally, Basel may have contributed at the margin to improvements in bank risk management because authorities might have promised extra rewards for adopting them. However, bank managers are smart people. They know that, in the end, safety-net design is a distributional battle that seeks to minimize "unfair" burdens and competitive inequities. Risk management is, in any case, a superior new technology for running a bank. Managers see benefits and

costs to it and make investments in it just as they would in anything else. The rate of return on improvements and the cost of the investments that improvements entail are balanced at the margin.

MR. BOOT: Yeah, again, to be really brief, because everything said so far I agree with. I think we need to really--maybe the point has not been made. Basel I, the minimum capital requirement, we should just recognize that that was an amazingly big success. It has raised, it has put in a floor that can be, there will some element of manipulation possible. It has put in a floor which led to a somewhat more level playing field, meaning that some fly-by-night operators had to operate at a minimum level of capital. It's like a certification requirement, a right to play in the industry. That was the whole ambition. It should not have the ambition--and that's where Basel II went wrong--that regulators can basically decide for the bank what the level of capital should be, and that's not necessary even because the industry chooses levels of capital which, fortunately, are much higher. So, apparently, it's optimal to have a higher level of capital

because you are far beyond the safety margin because, if there is a floor and below the floor you get hit with all kinds of punishment, you would like to be above the floor. So, the floor would still dictate where you are. But I believe that most banks operate and choose levels of capital which are above that level, which indicates that the regulator is not needed to fine-tune this level of capital.

I do agree with the point of view that this whole capital Basel II, in terms of risk management approach, has to some extent been an eye-opener. So, that has a benefit, but if the benefit is that we lose the possibilities of prompt corrective action--because that is what we would lose. We need the minimum capital requirement, which is the leverage ratio that Charlie was referring to, to have effective prompt corrective action. So, that we should not lose. That should be the first priority. So, we should preserve that.

Finally, on this comment on countries that came up with their own system and were forced basically to put it off, there is one very good example of a country that managed to overcome big international pressure, actually pressure from

World Bank and IMF of doing something that World Bank/IMF thought was the right thing of doing. That was Slovenia. Slovenia managed to get into the EU and into the euro based on its own economic policies which were strongly criticized by IMF/World Bank, and they thought that their own policies were best, and actually it worked out.

MR. CAPRIO: Let me turn to Ed first on the--I think Arnoud was suggesting before that known unknowns are the worst kind to have, but maybe you'll tell us more about that.

MR. KANE: I am going to redefine my question. This will help Charlie because I want to eventually take us back to Basel.

MR. CAPRIO: No, your question was so broad you could actually define it. [Laughter]

MR. KANE: Okay. My assignment is to ascertain what we have learned about what conscientious regulators ought to respond to? I can only answer what has changed my own past views of how to think about regulatory performance and to incentivize it better. This leads me to ask: Why is Basel II proving so hard to implement in the United States? Why is

the process virtually falling apart? Is this likely to happen in at least some other countries and why or why not?

The main thing I've learned is that national financial safety nets can be looked upon as incomplete social contracts. The contract's counterparties are the major sectors of some political or economic community.

There are three segments to the contract. My early research failed to recognize all three segments. One set of clauses defines and assigns responsibilities for preventing disruptive financial-institution insolvencies. Another set of clauses define a range of tax-transfer techniques for financing both the exercise of supervisory authority and the losses it fails to prevent. The third consists of clauses that dictate the political and economic incentives under which operators discharge their responsibilities--this is the part I always understood.

Let me begin by praising the concept of prompt corrective action. The beauty of this concept is that it defines, in a contractable way, the first set of responsibilities. Legislation doesn't fully specify the set of available tax-transfer techniques. Who ultimately pays

the bill will depend on the size of the bill and on the political clout of would-be bill payers and payees. But we have a much better understanding of the responsibilities for prevention at least.

From a contracting point of view, it is hard to say that Basel is a great success. My main fear is that the Basel II framework could undermine some of the advances the U.S. has achieved on changing the political economy of supervision and lessening regulators' accountability resistance. When we break it apart as a contract, the first thing that we find is that Basel II is not a treaty at all. A treaty is an agreement between signatories that represent the governments of sovereign nations. But who signed the Basel agreements? The regulators that happened to be in office in a few agencies in a few countries. Can they bind their successors in countries that experience a systemic crisis? No. But a crisis situation is what this session began talking about: About the existence of institutions that are too big to fail or too big to discipline adequately. We know that in a crisis, the incentive part of the safety-net contract deteriorates badly.

Basel II claims to have three pillars. One is minimum regulatory standards. The second is supplementary financial supervision. The third is supposed to be market discipline generated through enhanced disclosure. We can envision these pillars as part of a classic Greek temple: The temple's pediment is triangular, and the three pillars are tasked with holding it up. In Basel II, two of those pillars are completely hollowed out. The political economy of national implementation seeks to weaken the other. This is because capital standards are not going to be enforced uniformly across countries.

What makes the United States system better today than others is the accountability that the ideal of prompt corrective action imparts to the second pillar. Even in the U.S., for very large institutions market discipline is weak. But market discipline has improved mainly because regulators have to step in earlier and more firmly today than they would have in the past.

I would claim that Basel I and II are not even "accords" because they can't be said to settle the points at issue. That's what my dictionary says an accord is supposed

to do. Basel II is an incomplete contract. The elements of a good contract are two.

First, a good contract is easy to understand. Why is understandability desirable? Because fine print generates adverse options that are very hard to bring into view. One doesn't fully know what one is signing in a complicated contract. But the person who framed the opaque clauses does know.

Second, a good contract should create incentives for its fulfillment. That's where the supervisory clauses - those that concern the second pillar -- fail. There is no contract among the regulators as to what they will do in difficult situations: No operational rights or duties. Basel is ultimately about setting minimum standards. When a troublesome question is raised - e.g., "what will we do about interest rate risk?", the answer is to leave it up to individual-country supervision. There is no obligation specified there.

Contracting concerns stakeholders and stakes.

Counterparty stakes have two aspects: First, who gets what if the contract is fulfilled and what is the penalty for a

breach? Second, how do counterparties remedy a breach? Nothing in the Basel contract spells out remedies for breaches. And without clauses that define a system of prompt corrective action, countries cannot even contract over the relevant action space.

I could go on and on about the gaps that exist in contractual rights and duties. Instead, let me try to clarify what's happening in the United States and why it helps to think of Basel(T) rather than Basel II or IA. Even in the Committee on Banking Supervision in Basel, one saw a continual expansion in the number of players. As financial-services authorities were created in different countries, they were welcomed aboard the Basel Committee. Counterparties and negotiators kept expanding. In the United States, we are seeing a similar expansion of the bargaining table today, and this expansion will occur in at least some other countries, too.

As I see it, United States negotiators went to Basel with implicit understandings about what they could agree to. Each U.S. representative represented its own special regulatory constituency. It would be foolish of these

representatives not to consult directly with important players among their clientele. For the Fed, this means the biggest banks and financial holding companies. After consultation, specific agents went to Basel and negotiated things and came back with a document. The preliminary agreements with their domestic constituencies were not cleared and shown to one another. This all but assured that Basel II would prove inconsistent with constituency expectations.

The stakes of the different regulatory constituencies are surfacing clearly now. Let us take the Office of Thrift Supervision (OTS) as an example. Its leaders want to defend the thrift charter. They don't want anything in Basel that might make other financial institutions, such as large and complex banks, stronger at their constituency's expense. And they want an unrealistically low risk weight assigned to every kind of mortgage. A low weight for mortgages turns out to be a necessary deal-making ingredient. This is true even though the greatest risk to the financial system today may lie in imprudent real-estate lending.

What is the role of the FDIC? The FDIC was a party in

the sense that it sent a representative to Basel, but the FDIC differs from the other federal agencies in being bound in an accountable way by FDICIA's provisions for prompt corrective action. The FDIC pays the bill if prompt corrective action doesn't take place. So, its leaders are unwilling to give up the simple leverage ratio as a trigger for intervention.

At the Fed, Susan Bies is the lead player in Basel today. She said at one point that she thought that "down the road" the leverage ratio had to go. I think that statement shocked leaders of the FDIC and led to a formal inter-regulatory agreement to preserve the system of leverage-ratio tripwires. In turn, this agreement is now causing large banks to try to renegotiate their options under Basel II so that they can choose among the same range of optimal regulatory standards as banks headquartered in other countries can.

It is ironic to remember that the Fed first sold the whole idea of Basel to other countries as a way of getting uniformity in standards across national borders. What we're seeing now is that the U.S. system is going to remain

distinctly American. I think we will see nationalistic biases in most other countries as well. Something like eighty-two options in the 2005 Basel agreement are left to be settled at the country level.

MR. CAPRIO: Thank you, Ed. I should point out, by the way, that Ed supplied the paper which is available outside.

And now I'll open it up to our other panelists.

MR. ROSENGREN: I'll do a clarification.

MR. CAPRIO: Okay.

MR. ROSENGREN: One clarification: I think all the federal supervisors in the U.S. have said they're going to keep the leverage ratio. So.... I think there have been a number of speeches by Sheila Bair that have said they're going to keep the leverage ratio, so I don't think it's an issue. Basel and whether we keep the leverage ratio--it's not one or the other. I think everybody has stated pretty clearly they're planning on keeping the leverage ratio.

I would also mention that when--one reason that banks frequently have more capital than the minimum is they use a different soundness standard. So, 99.9 percent is the soundness standard for Basel; 99.97 is the soundness

standard that most banks use when they do their internal capital. They have to figure out how much capital they want to hold. Every time you decide a stock buy-back, your dividend payment, any of those decisions, you have to say, how much capital should I hold? The way that big banks do that is by models. Now, the models may not be perfect, but you already--every time the bank has to make a decision about "Do I hold more capital or less capital?" they are using models that are very similar to the Basel accord. And I think the Basel accord has provided a little more structure, but it is a minimum requirement; it's not a maximum requirement. And most banks are going to hold significantly more than the minimum.

MR. CAPRIO: Maybe I should reverse course. Unless there's a two-handed intervention by a panelist, can I open it up to the floor for questions? And then I'll give the panelists time to sum up or make final comments.

MR. PENNACCHI: I want to go back to the beginning and address the issue of too-big-to-fail. I agree that it's critical that banks be required to improve their information systems so that regulators can know exactly or very close to

exactly what their level of insured deposits are. So, the current FDIC proposal to improve information is certainly a step in the right direction.

Now, I'd go a step further to the assets side of the balance sheet. It seems peculiar to me that we give the Federal Reserve and the Federal Home Loan banks more power than the FDIC in the sense that when the Federal Reserve lends to banks through the discount window, or the Federal Home Loan Bank Board makes advances, they require high-quality collateral for their advances. We don't do that with the FDIC, and I think we certainly could do that with some very large banks, because insured deposits are often a very small proportion of their total liabilities. They could be 15 percent, 10 percent even.

So, it appears that if we want to make it easy for the FDIC to resolve a failed bank, we should put in place some security that the FDIC can, secured assets that the FDIC can quickly use to pay off insured depositors. And then, we're in the situation of perhaps not completely eliminating too-big-to-fail, but we're at a point where the rest of the bank would be treated as if it was, say, Goldman Sachs failing or

Drexel Burnham failing or LTCM failing.

So, at least we take out one aspect of the excuse that we need to implement a too-big-to-fail exception by making it easy, at least, for the FDIC to resolve their claims on the bank.

MR. CALOMIRIS: Well, I'll just say that I really like the idea, and I think that there are countries that have had liquidity requirements, liquid asset requirements as a proportion of deposits, and that's kind of related, not exactly the same, but related to what you're saying. And it's interesting to ask, why are we so focused on just capital?

MR. BOOT: I also have a question about too-big-to-fail, but this time it's about the scope. Should we just look at commercial banks? Should we also include, say, Fannie Mae in the too-big-to-fail argument or, for that matter, Fidelity, for example?

MR. STERN: Well, I guess I'm not sure what you mean by include it in our discussion. I've had a lot of casual discussions with Federal Reserve policy-makers and others over the years about, gee, you know, if you're really

serious about contagion effects and so on and so forth, then you've got to be worried by a lot more than just large commercial banks. You know, you can think of large investment banks that are operating globally. That's certainly true. I don't know about somebody like Fidelity.

I haven't thought so much about them, but certainly large investment banks.

Now, you know, it's easy to think about it and talk about it casually. When you start to really get into it, I think there's two things occur to me right away: One is, of course, you'd better be careful what we publicize here for moral hazard reasons and other things, although perhaps, perhaps people in the marketplace think Goldman Sachs is too big to fail and that there is some implicit protection offered to its creditors.

The other thing is, you know, Drexel Burnham was wound down gradually over time, but I don't think, at least it's my perception of that episode is that it did not exacerbate moral hazard problems and so forth. So, perhaps, because of the nature of their liabilities, you can deal with investment banks effectively, while commercial banks present

you with a different set of challenges.

MR. KANE: I think that what you have to look at is whether the value of assets and liabilities on an institution's balance sheet can move in different directions. In this respect, the great thing about a mutual fund company is that they're just a portfolio-management company. Management is all they do. Each of the funds they manage has assets, but the value of fund liabilities are perfectly correlated with the value of the assets. In bad times, this arrangement accomplishes the depositor recapitalization that New Zealand has been talking about. So, taxpayers don't have a parallel exposure there.

Fannie Mae is a great danger simply because it has become so big. It trades on implicit guarantees inherent in its being "too big to discipline adequately." The government is unwilling to take the kind of action necessary to eliminate the guarantee. GSEs pose an agenda of a perennial reform issues, but the GSE's repeatedly find ways to block fundamental reform. In the face of accounting scandals that gave them a huge black eye, they're better supervised today than before. Still, the GSEs persuaded Congress to posture

rather than to act decisively. Fannie Mae is probably the best lobbying company in the world.

MR. STERN: Or at least they were. The amazing thing about Fannie Mae is they themselves determine the size of their subsidy. I mean there is no way under the sun that that's good public policy.

MR. CAPRIO: John?

MR. BOYD: This is not question. This is more an observation, and it has to do with how quickly times change, and that is this notion of this trade-off between competition in banking and stability. As that topic has come up today, people have said--several people, you know, really smart economists have said, "Oh, I don't think there is a trade-off," or "There may or may not be a trade-off." Well, not so many years ago, a few years ago when Gianni and started on this project--now Gianni, I, and Tariq work on this--we were told by some quite good and eminent economists that we were basically morons. So, times really.... Many of you will remember a number of years ago, Mark Gertler and I wrote a very simple descriptive paper, "Are Banks Dead? Or Are the Rumors Greatly Exaggerated?" and all

we did was show in that paper that, in fact, this notion that banking share of financial intermediation was declining, that once you took account of off-balance sheet activities, it totally reversed that conclusion. Well, again, as soon as we wrote that paper, everybody said, "Oh, I knew that." But things do move pretty promptly.

MR. CALOMIRIS: [Off-microphone] because I knew you were not going to let me talk twice. [Laughter]

I want to make a big-think reaction. I thought--by the way, I don't want to get into all the details of reacting on Basel II. I thought Eric's points were good points. But I want to give a big-think reaction on the whole idea of how we model risk in the economy. And I guess I'd say I'm a democrat, with a small "d," and I'm also a Hayekian. And Friedrich Hayek's basic insight was that nobody is smart enough. That's really his insight about why we don't want to have central planning. We've actually learned, and I agree with Eric that all the disagreement from the current quantitative assessment is going to be reduced. We're going to get agreement. The banks and the regulators are going to agree much more about risk rates. That doesn't mean they're

going to be accurate about it.

We've run this play before. I teach it. In fact, at Columbia, I was teaching before I came here today. CFS, Inc. was one of the great scientifically modeled achievements of 1997. It was a securitization operation that did charge-off credit cards. Credit cards were growing very rapidly. They had very scientific models. They had about \$1.6 billion of debt outstanding at the time that they went belly-up, of which 70 million was repaid to creditors.

But this was engineered. This was financial engineering done by Fitch and Duff & Phelps and S&P, based on stress tests, which are in a multi-trillion-dollar securitization market that's still being done today. But what was the problem? The problem was to get your single A-rated securities placed, what you had to do was satisfy a single model. The engineering for this comes out of the very conflicted ratings agencies that engineered these.

Financial markets have learned not to trust consensus models of risk. They're learning that from twenty years of experience in securitizations. How come the Basel Committee and our regulators haven't learned that? We're going to get

a consensus and it's going to be exactly wrong.

The way markets act is they disagree. Market participants disagree, and those disagreements are reflected in prices. We want to have that, alongside models, at least as belt and suspenders, because as soon as we get a consensus model enforced by the Fed, boy, we're in big trouble. If you thought Duff & Phelps was bad, just wait.

MR. CAPRIO: I think that's going to elicit some comment. Arnoud?

MR. BOOT: Yeah. Let me disagree to some extent, because from the discussion we know the many issues we agree on.

Talking from European experience, and I think that might be important in this case, one of the big problems that we have, and to some extent you have that in the U.S. too, is some type of harmonization in the regulatory/supervisory practices: There's a lack of harmonization. There's also a lack of authority. Who has the authority? So, it is European Union, if it comes to supervision; if it comes to lender of last resort, as was being mentioned, it is a system of subsidiarity. So, it is

with the member states, not with Brussels.

So, now the question is, this dispersed system of regulation and supervision that exists in Europe, how can we get more harmonization and more central authority in that system? Then you can ask the question, is there a need to have some harmonization? I believe there is some need in having harmonization. Very dispersed practices across countries are not sustainable, definitely not if banks move cross-border. We need some harmonization of practices.

Do I share Charlie's concern about Basel II, that we all are using the same model? Yes, I share that concern. It has been my criticism of Basel II very often as well. We're all going after one model, and the model might be wrong. So, we are all simultaneously wrong, so Basel II is creating a systemic problem in the whole banking system because we all go after the same model. So, that's absolutely true.

So, what Basel II in a sense, you could in its defense say Basel II doesn't force you to have the same model; however, we know how things work. You need to have certification of your systems, so--and we know we don't have

two consultants, consultancies. Forget about the credit rating. If you're going to have two consultancies in the world that take the market share in implementing these type of systems, and what do consultants do? What do the MacKenzies and the Boston Consulting Corp. do? They have learned one system from a client and they apply it to the other client, so all clients end up with the same system.

Regulate, it's the same thing. It's much easier to get--supervise the same thing--to get it supervised if you do what the other did than if you do something special. So, it's inherent in human behavior that they're doing herding.

So, now the question is are we going to blame Basel for the herding? I'm not absolutely sure we should do. I'm not absolutely sure. We have to ask the question, how can we create, how can we be more open to different approaches? And maybe we should do an effort there. But it is inherent in human behavior that we do this herding.

And actually, to your--one comment on that. The legitimacy of Basel, you said regulators have signed for it. Yes, they initially signed for it, but it is being part of--new directives--it's being written in detail and new

directives. And assuming that we give some legitimacy--I shouldn't use words I cannot pronounce--that we can, that has been approved

--let's use that word--by European Union, and assume the European Union, which is not, is being democratically voted on by the population of Europe, then at least we have taken care of that issue.

MR. KANE: Just one point. Didn't two nations reject the constitution? I mean that's like--

MR. BOOT: It's not in the constitution. Fortunately not, because we will never agree on the constitution, and that will be the end of Europe. So, the constitution is out of the picture. It is EU directives, and EU directives need to be implemented in national laws. So, we have no choice.

We have to do it. So, that makes it--since this process, for one reason or another, got its movement in that direction, each country has to do it.

MR. CAPRIO: Okay. We've got one by Eric and then Ross had his hand up.

MR. ROSENGREN: It's not one model; it's a framework. If you go to the banks, they have very, very different

models. When I go for an operational risk exam at the various institutions, one institution heavily uses internal data; another one uses external data; another one does scenario analysis. They're not that similar.

On the credit side, there's PD, LGD, and EAD. People are getting very different ways of getting the probability of default, loss given default, and exposure at default. When you plug those three things in, yes, there is a formula that is in there, but it isn't one model. They're very different approaches. There's very different data. There's very different risk tolerances that are exhibited in how it's being used. So, it's a framework, not a model, and I'm not nearly as worried about everybody having the exact same one. I'm seeing no evidence that that's actually happening among the organizations that I've been in.

MR. LEVINE: I guess I want to push the discussion back toward developing countries, and also maintain the focus on centralization of power. And on this, I would suggest that I have greater fears that what will happen is that a model will be imposed by a central authority on the banks in that country, or the banks themselves will decide what model is

going to be imposed on them by the regulators.

And so, from this perspective, I tend to very much agree with Charlie's concerns, and that is, as Basel is implemented or imposed around the world, if it is, what this will involve is a centralization of power in official regulators. And I see no reason to have much faith that these regulators are going to act in the best interests of their citizens, and a lot more evidence to suggest that they're going to use that power in order to achieve political aims. And that it's the focus of Basel on the discretionary power in the supervisory agency that I see as the biggest risk around the world, and I think that there's a reasonable amount of evidence, both within the context of banking and certainly within the context of other policies.

MR. CAPRIO: Other comments?

MR. LEHAR: I have a question regarding Basel II. So, it seems like that regulators want to tie capital requirements more to total risk, but if banks reduce capital requirements for reducing total risk, that means that in the end, banks will diversify more and end up with very similar portfolios and increase the correlation amongst portfolios.

So, that might reduce the individual default probability of a bank, but it might increase the correlation. And if a big economic shock comes along, that means that all banks have the same portfolios, all banks will default at the same time. So, is this an issue that you see as a problem or not?

MR. CALOMIRIS: Let me just restate to make sure I understand what you're saying. If there's some, let's say, incentive buried in the Basel standards, call it a "bias," in some kind of model, even though Eric calls it a "framework," that drives you toward a particular class of assets, you're saying all the banks will face a similar bias and therefore their portfolios will become more correlated. Is that it?

MR. LEHAR: I think if you want to reduce total risk from portfolio theory, what you want to reduce is incur credit risk because that is not rewarded and in the end all banks will hold up the market portfolio, and that means all banks have the same portfolio, and that will probably cause an increase in systemic risk. So it might be probably interesting to reward somehow using credit risk in a capital requirement because even though an increase in credit risk increases bank default probability, it might be the case

that in some situations at least not all banks default, that you have some surviving banks that can take over business from defaulting banks.

MR. CALOMIRIS: I have a different proposal about how to fix the problem you're talking about. Suppose that there are five factors in systemic risk, and since the question is, "What weight should the factors get in the bank's portfolio risk model?" and I think your point, which I would agree with is, if it turns out that the banks' aggregate portfolio is more weighted toward some factors than the global economy is, that you might want to require the banks to hold higher capital on that factor as result of the fact that the banks happen to be having a greater weight. In aggregate, the banking system is more weighted on that factor. So I wouldn't think it is in credit risk is the issue still. I would think it what are the factor loadings for the banking system differ from the factor loadings of the global economy. But I think that would address your point, wouldn't it?

MR. KANE: One of the ways that I think about regulation today is to think that - actually regulators don't impose it on banks. Banks impose it on regulators. Banks say, "This is what we live with. Take it or leave it." And then you

negotiate a little bit around the margins. So that the Basel II that we got was very comfortable for the large banks of this world, and so the EU was able to say, "Terrific, we'll put that into the directive." Coming back to the United States everything looked great until the QIS 4 came out and suddenly the importance of the prompt corrective action and the leverage ratio came back and now the large banks are trying to ask, "Can we have the same three choices on our system that the European banks have. But what they're really saying is, "We want to find a new solution and we'll put this back into bargaining in the United States.

End of TRANSCRIPT