

Two Key Issues Concerning the Supervision of Bank Safety and Soundness

DWIGHT M. JAFFEE

The author is the Willis Booth Professor of Banking, Finance, and Real Estate at the Haas School of Business at the University of California, Berkeley. This commentary was presented at the conference "Safe and Sound Banking: Past, Present, and Future," held August 17–18, 2006, and cosponsored by the Federal Reserve Banks of San Francisco and Atlanta and the founding editors of the Journal of Financial Services Research.

As Mark Flannery notes, it is a luxury to be asked to prepare a paper to identify major current questions regarding bank safety and soundness. It is an even greater luxury to be asked to comment on Mark's list of questions, particularly since I agree with every topic on his list. In this commentary, I will focus on two specific issues. The first, raised by Mark, asks, What are the market failures that actually create the need for the public regulation of bank safety and soundness? The second, which Mark omitted from his list but is at the very top of mine, concerns the safety and soundness issues created by the two mortgage government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.

Safety and Soundness Supervision Derives from Some Market Failure

Mark opens his paper by asking why bank safety and soundness is a question of public regulation in the first place, obviously a key question. Mark's answer, with which I agree completely, is that safety and soundness regulation must derive from some market failure. But Mark does not drill down to a full answer. Since the answer will determine whether we actually need bank regulation and, if so, what the best form is for this regulation, I will try to provide a more complete answer.

A simple explanation of why we need bank regulation is, of course, to avoid frenzied bank runs. That answer may have been a sensible one in the 1930s, but today I think we must consider whether capital market liquidity is now sufficient to extinguish irrational bank runs. After all, the breadth and depth of our capital markets is one of the key strengths of the U.S. economy today. If capital markets can actually provide bank liquidity, then we can save the money and effort currently invested in this aspect of bank regulation.

Let me make the case for capital market liquidity. Suppose I manage the Jaffee Bank of Berkeley, taking in deposits and making sound loans, but the maturity of my loans exceeds the maturity of my deposits. Unfortunately, one day a bank run is initiated against the big banks in San Francisco, causing concern even among the depositors at the Jaffee Bank. My solution would be simple and direct: I sell my port-

folio of loans in the capital markets, using the proceeds to pay off my depositors. I am not happy about the event because I lose the profit spread I was earning, but the situation is not disastrous. In fact, my reputation for paying off my deposits is enhanced, and when the bank run panic subsides, I can regain my deposits and repurchase my loans. As long as I can depend on capital market liquidity as an outlet to sell my loans, I have no need for government liquidity and for the bank regulation that it creates.

The problem with this story, of course, is that the U.S. capital markets do not seem able, at least on a consistent basis, to provide this type of liquidity. Instead, we observe capital market liquidity crises in which market investors are suddenly unwilling to invest at all—or investors quote risk spreads that amount to the same thing—even though on the previous day identical securities were bought and sold in liquid and deep markets. Even more interestingly, the trigger events that create such capital market crises often seem very remote from the security markets that face the crises. I am thinking of the recent crises that started with Russian government bonds or Asian currencies but ended up dramatically raising the risk spreads for such securities as U.S. residential and commercial mortgage-backed securities. Since no obvious link exists between Russian bonds and U.S. mortgages, why the liquidity crisis spread in this way is an intriguing question. One answer, just now being developed in research papers, is that investors foresaw a possible chain of broken financial contracts and thus became extremely conservative in their willingness to invest until the crisis abated (see Caballero and Krishnamurthy 2006).

I suggest that this tendency of capital markets to expand panic to sectors with no direct links to the initial crisis underlies the need for public regulation of bank safety and soundness. After all, if the capital markets cannot dependably provide liquidity, then frenzied bank runs will occur, and a lender of last resort at the Federal Reserve and a deposit insurance fund can make sense.

Moreover, I suggest that this market failure also has implications for other financial services. As an example, Thomas Russell and I have a series of papers about how the failure of private markets for catastrophe insurance has led to inefficient government interventions in these markets (Jaffee and Russell 2006). The examples include the creation of federal flood insurance starting in the 1960s, the breakdown of Florida wind-damage insurance due to Hurricane Andrew in 1992, the failure of California earthquake insurance due to the 1994 Northridge quake, and, most recently, the breakdown of terrorism insurance due to the 9/11/2001 attack. It is understandable, of course, that the price of these catastrophe lines could rise after an event, especially if insurance firms raise their estimates of expected future losses. It is not easily explained, however, why large parts of the private insurance industry simply refuse to offer policies the day after the event even though they were doing so quite happily the day before. Russell and I believe the explanation is a capital market failure, in which catastrophe insurers find that their capital market access has dried up as a result of the event even though their business is expected to be very profitable as market premiums rise.

The connection here is that we see government interventions in a wide range of financial services—from bank deposits to catastrophe insurance. In all these cases, we must understand the underlying market failure in order to evaluate whether and how that intervention should occur. I believe it is of fundamental importance to provide a full answer to this question.

A New Item for Bank Supervision: Fannie Mae and Freddie Mac

The second issue I will discuss concerns the two mortgage GSEs, Fannie Mae and Freddie Mac. Mark Flannery does not include the two GSEs on his topic list, but I

Table
U.S. Capital Market Obligations by Sector

	Year-end 2005 (\$ trillions)
U.S. commercial bank liabilities	\$7.7
U.S. Treasury debt	\$4.7
Total obligations, Fannie and Freddie	\$4.2
Fannie Mae obligations	\$2.4
Freddie Mac obligations	\$1.8
All corporate bonds	\$3.0
All commercial loans	\$2.4
All municipal bonds	\$2.2
All (nonmortgage) consumer credit	\$2.2

Note: Fannie Mae and Freddie Mac obligations equal total debt plus net mortgage-backed securities outstanding.

Sources: Federal Reserve Flow of Funds, Table L.2; for Fannie Mae, *Debt Activity*, December 31, 2005, and *Monthly Summary*, April 2006; for Freddie Mac, Caballero and Krishnamurthy (2006)

consider them a major factor threatening commercial bank safety and soundness today. The source of the problem is that Fannie and Freddie currently embed very large amounts of interest rate risk in their retained mortgage portfolios (Jaffee 2003). One might think that Fannie's and Freddie's financial distress is a problem only for investors holding their obligations or for their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), and not for the commercial banking industry. The financial obligations of the two firms, however, are now so large that they create a very serious systemic risk that could envelop all the U.S. financial markets, including the commercial banks. The table provides some summary statistics showing that Fannie and Freddie are larger

than whole sectors of the U.S. capital market, with their capital market obligations exceeding the total amounts for all corporate bonds, commercial loans, municipal bonds, and nonmortgage consumer loans outstanding in the U.S. capital market. Specifically, with respect to U.S. banks, consider these facts as of year-end 2005:

- Fannie's and Freddie's total obligations equaled \$4.2 trillion, representing 55 percent of total U.S. bank liabilities. (At year-end 1985, in contrast, the two GSEs' obligations represented 8 percent of total U.S. bank liabilities.)
- Fannie and Freddie were larger than any U.S. banks based on total obligations.
- Fannie and Freddie would both be among the top six U.S. banks based on assets.
- Investments in Fannie's and Freddie's obligations exceed 14 percent of all U.S. commercial bank assets.

Congress has been considering bills for reorganizing the regulation of Fannie and Freddie, indicating further concern with their safety and soundness (Glaeser and Jaffee 2006). One response, especially by Freddie Mac, has been to argue that the regulation of the two GSEs for safety and soundness is already on par with that of commercial banks (see, for example, Syron 2005). I think it is important for bank regulators to hear this argument and to rebut it. Here are some of my notes for this rebuttal:

1. **The U.S. Treasury does not backstop the Federal Deposit Insurance Corporation (FDIC).** Fannie and Freddie have a direct credit line at the U.S. Treasury, and capital market investors generally assume that an implicit U.S. Treasury guarantee exists on all of Fannie's and Freddie's obligations. In contrast, the FDIC provides only a mutual guarantee among all the banks, with no links whatsoever to the U.S. Treasury.
2. **Bank capital requirements far exceed those of Fannie and Freddie.** The effective capital requirement for the two GSEs is just over 1 percent, reflecting a weighted average of 2.5 percent for their balance sheet assets and 0.45 percent for their mortgage-backed security guarantees. Most banks, of course, carry capital ratios in excess of 8 percent. In addition, banks hold diversified portfolios

while Fannie and Freddie mainly hold a single asset class—namely fixed-rate, long-term, freely prepayable mortgages.

3. **Bank regulation includes prompt corrective action (PCA).** As discussed at this conference confirmed, PCA has greatly expanded the safety and soundness of U.S. banking by creating a mechanism through which distressed banks must either add to their capital or merge. The regulation of Fannie and Freddie has no comparable power, leading to a serious concern that financial distress at either firm would lead first to forbearance and, later, to a federal bailout.
4. **Risk diversification.** Financial distress for Fannie and Freddie would focus on just two firms, with the likelihood that any serious issue at one firm would migrate quickly to the other. With over 7,000 U.S. commercial banks, the risk would be dispersed over many more firms.

In closing, I will return to Mark Flannery's list to highlight an important issue of high relevance for both Fannie and Freddie and for bank regulation: the Basel II proposals for capital adequacy. The current proposals will reduce the capital requirements imposed on residential mortgages, whether held as whole loans or as mortgage-backed securities. This reduction will expand the incentive for banks to hold these loans and securities, which is a good thing if it creates a reduction in the retained mortgage portfolios held by Fannie and Freddie. On the other hand, we should not forget that Basel II has no direct capital requirements for interest rate risk. For me, the highest priority is to create a capital requirement system in which interest rate risk is treated as a fundamental risk factor, with its own quantitative capital requirements, quite on par with those for credit risk.

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