

Again?

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Purpose

Raise concerns about growing incentives for excessive risk-taking—potentially more consequential than 2008.

- Each observation below is dismissible, as similar observations were dismissed in 2004-2008.
- Together, they are concerning, especially since there seem to be few forces pushing for a reversal.

Motivation

Why worry about government-generated excessive risk-taking?

(“Excessive:” Risk above that chosen in a distortion-free world.)

4 Reasons to care about excessive risk-taking (ERT)?

1. **ERT can trigger crises, with obvious costs.**

- Unemployment, debt, and bankruptcies.

2. **ERT harms efficiency and potentially long-run growth.**

- Does not simply move society along the efficient social risk-return frontier.
- More σ , but not necessarily more $E[r]$.

3. **Government-generated ERT can harm governance and efficiency.**

- Such policies often weaken incentives for debt-holders, boards, and counterparties to scrutinize management. Governance worsens.
- Financial firms become worse in general, not just riskier.

4. **The political ramifications could be extraordinary.**

My Concern ...

Government-generated excessive risk-taking

- **Two ways to constrain excessive risk-taking**
 - Private market discipline.
 - Public regulation and supervision.
- **Two ways governments amplify excessive risk-taking (ERT)**
 - Backstops that weaken private market discipline.
 - Weakening regulations and supervision that constrain ERT.

The U.S. is weakening (1) private market discipline and (2) effective public regulation and supervision.

10 observations

Done quickly

1. Extraordinary Crisis-Triggered Expansion of Backstops

- Bailouts of everything in 2008
- Dodd-Frank formalizes backstops.
- 2023 Responses to First Republic, Silicon Valley Bank, and Signature expand expectations of backstops.

2. Enhanced Supplementary Leverage Ratio (eSLR)

Non-risk weighted capital floor

- Cut at GSIB.
 - Reduction in Tier 1 capital of over \$200 billion.
 - Concentrated within insured depository subsidiaries.
- Likely great government-generated excessive risk-taking.
 - Less private skin-in-the-game.
 - Weaker private constraints on excessive risk-taking.

3. Alternative Investments in 401(k) Plans

- Executive Order and actions by the DoL and SEC:
 - Lower regulatory and litigation barriers to placing private-market assets in defined-contribution plans.
- These are often illiquid, hard-to-value investments.
- Potential backstop expansion (\$12.2 trillion)?
 - In 2008, the Treasury guaranteed all money market fund assets within days because retiree savings were at stake.
 - 401(k) changes could expand the backstop, boosting government-generated excessive risk-taking.

4. Expand Credit-Score Models for Housing

- Federal Housing Finance Agency's acceptance of VantageScore 4.0 for GSE mortgages.
 - Expands the set of accepted credit-score models.
 - Estimates of a \$1 trillion increase in federally guaranteed mortgages.
- Increases the government backstop by expanding access to it.
- Intensifying government-generated excessive risk-taking.

5. Insurance and Bermuda

- U.S. life insurer reinsures with a Bermuda reinsurance affiliate
 - Lowers capital requirements at U.S. life insurer.
 - Bermuda reinsurance affiliate faces lower capital requirements and is outside the U.S. supervisory perimeter.
 - U.S. insurers moved \$800 billion of reserves to higher-yielding, less-liquid assets in these offshore affiliates.
- Expected backstop expansion
 - If a major private-capital-linked life-insurance structure failed, policymakers would face intense pressure.
 - 2008 AIG is the precedent.
 - TITF → government-generated excessive risk-taking?

6. Deposit Insurance Expansion Proposal

- Expand FDIC insurance to \$10 million for some business transaction accounts.
- Formalize and regularize 2023 crisis actions:
 - The Systemic Risk Exception covers all uninsured depositors
 - The Bank Term Funding Program lent at par against impaired collateral as a standing policy.
- Likely to generate expectations of a more extensive backstop, i.e., it strengthens government-generated excessive risk-taking.

7. Fed's Standing Repo Facility (SRF)

Wenxin Du has covered this in depth.

- SRF lends to dealers.
- Dealers' tail risk falls; haircuts to hedge-fund basis trades compress.
- Hedge funds leverage up their basis trades—Cayman-domiciled hedge fund Treasury holdings have risen \$1 trillion since 2022.
- If things go badly, the public, via the Fed, absorbs the cost.
- By backstopping dealers, SRF can be a source of government-generated excessive risk-taking by hedge funds.

8. Genius Act: Stablecoin reserves at banks

Profs. Acharya, Du, and Seru are experts.

- GENIUS does not explicitly extend FDIC insurance to token holders.
- The concern is a run-transmission/political-rescue channel
 - What if a large issuer keeps reserves as uninsured deposits at a bank.
 - What if there is a run on the bank?
 - Will there be severe political pressure to protect token-holders, many of whom will believe themselves protected?
- Government-generated excessive risk-taking?

9. Fed Restatement of Supervisory Principles

- The Fed's November 2025 release:
 - **Creates a much higher burden of justification for every supervisory action, e.g., Matters Requiring Attention/Immediate Attention.**
 - Peer "horizontal reviews" curtailed.
 - Consumer-compliance examination cycle: 24–36 to 54–78 months.
- Also, plans to reduce staffing by roughly 30%.
- Potentially weakening of supervisory constraints on excessive risk-taking.

10. Bank Audits

Public Company Accounting Oversight Board (PCAOB)

- Bank supervisors rely on the bank's audited financial statements as their starting point for everything. **They are the basis.**
- A bank executive deciding on an aggressive accounting position considers the probability that the auditor will push back. **The auditor's position depends on the PCAOB.**
- PCAOB enforcement actions dropped precipitously in 2025-6.
- The very basis of official supervision and regulation has been eroded.

There are more ...

- Potential reduction in Call Report information.
- OCC and FDIC withdrew the Interagency Leveraged Lending Guidance on December 5, 2025 — the framework that had set supervisory expectations for highly leveraged loans since 2013.
- Nonbank supervision reduced: CFPB planned to cut supervisory events by approximately 50%.
- Nonbank transparency reduced: CFPB's October 2025 final rule rescinded the Nonbank Registry Rule, which had required nonbank financial firms subject to enforcement orders to disclose those orders.

Final Remarks

Review of excessive risk-taking incentives

Two ways to constrain excessive risk-taking

- Private market discipline.
- Public regulation and supervision.

The U.S. is weakening:

- **Private market discipline**
- **Public regulation and supervision.**

Are There Countervailing Forces? Reforms?

- No.