



The Future of Finance is Very Uncertain

Christopher Papagianis | August 26, 2010

Earlier this week, FDIC Chair Sheila Bair argued that the “road to safer banks runs through the Basel process.” While she correctly defined many of the objectives in her FT op-ed (i.e. achieving higher and more meaningful capital requirements for banks), her optimism about how the current process is unfolding is worrisome.

The next stage of financial regulatory reform in the U.S. will be through regulatory rulemakings – government agencies will convert legislative guidance from Congress into concrete rules to govern the operation and risk-taking of financial firms. The Dodd-Frank Act requires 243 rulemakings and 67 studies. Then there is the Basel Committee on Banking Supervision – an international cooperative forum that develops global guidelines and supervisory standards for banks – which is working to update its own capital and liquidity rules.

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One immediate byproduct of Dodd-Frank and the new Basel standards has been to raise the level of uncertainty facing financial firms (contrary to the Administration’s claims regulatory reform has reduced uncertainty). During the recent earnings season, many CFOs were unable to provide investors with guidance on the likely effect of Dodd-Frank on firms’ profitability because they didn’t know themselves. As Goldman Sachs CFO David Viniar explained, “the actual rules are going to be written by the regulators, they’re not going to be written for

probably 15 months, then the transition periods as you know for many of the businesses are quite long, in some cases up to five years beyond that, and so it’s just extremely hard for us to quantify right now.”

These rulemakings matter because Congress decided against creating clear and conspicuous rules on leverage, balance sheet size, and margin requirements. Instead of establishing rules and allowing the market to function, the Dodd-Frank bill created a process by which relevant stakeholders and regulators collectively decide on the parameters of financial intermediation going forward. The potential distribution of outcomes is wide, with onerous capital and liquidity requirements on one end and virtually no change in previous practice on the other.

The Basel Committee recommended establishing a 3% minimum capital standard. This means that banks could be leveraged no more than 33-to-1, though this standard would not be binding until 2018. At the outset, it would also be based on “total capital,” which would be calculated using debt-like hybrid securities instead of limiting the definition to shareholders’ equity. Total capital is a much broader concept that permits things like convertible debt, some deferred tax assets, and subordinated debt to count as equity even though these entail real financial obligations that the firm must meet. As of May 31, 2008, Lehman Brothers was leveraged only 24-to-1 (which was also its last filing). Its \$639 billion of assets were financed with only \$26.2 billion of total equity. How can one take seriously a new regulatory standard where Lehman’s leverage was 27% below the allowable limit?



The variance of a large, complex portfolio is very difficult to estimate even if one is aware of how the returns on the portfolio are distributed. But, no one really knows how common an occurrence a 3% decline in the market value of such a portfolio really is. All we really know is that it was far too little relative to the disruption of 2008. Regulators should recognize the inability of models to capture correlations across asset returns in stressed markets and build in more capital to account for these limitations. In any event, U.S. banks will be held to a higher standard of 5% of adjusted assets in most circumstances. (It is also worth noting that the proposed changes in the definition of Tier 1 capital and new liquidity standards would certainly increase the safety of the banking system).

Prior to the recent announcement, the Basel Committee had no minimum capital standard. All capital and leverage requirements were based on risk; the riskier a portfolio of assets, the more capital a bank would have to hold as a buffer against it. As explained by Princeton professor Markus Brunnermeier, this created openings for banks to “game” their balance sheets by repackaging the same assets in different, supposedly less risky, securities to reduce their capital charge. It is also predicated on the flawed premise that banks or their regulators have sufficient knowledge to measure precisely how risky securities are, either individually or in conjunction with other assets.

The introduction of a minimum capital standard – however inadequate – was a victory for the U.S., which argued for a minimum capital rule that made no reference to risk. The problem is that Secretary Geithner has always emphasized the centrality of tougher capital and leverage standards to the Administration’s reform efforts. If all the Basel Committee could muster was a 33-to-1 maximum

leverage ratio in the face of lobbying from influential industry groups arguing that more capital equals less lending, what are the chances for tough new rules from the U.S. regulators?

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In a world where capital can move freely across borders – often through internal capital markets as money is transferred between subsidiaries of the same large, integrated financial institution – it seems highly unlikely that individual nations’ regulatory standards could be materially more stringent than international norms. The U.S. banks will likely protest at their slightly higher leverage ratios and describe any incremental charge as pushing financial services overseas.

Insufficient capital is likely to be an even bigger problem today than it was in 2008. This is because the financial reform bill (and bailouts of 2008) intensifies perceptions that large financial institutions are “too big to fail.” The logic of the Dodd-Frank bill was that the government needs “tools” to resolve large financial institutions when they get into trouble. Even Former Treasury Secretary Hank Paulson commented on how he would have loved to have these tools in the fall of 2008. The problem is that the absence of legal authorities is not what made certain large firms “systemic.” It was, rather, the inability of these firms’ creditors to withstand losses without creating cascading impacts on the rest of the financial system. If these creditors remain undercapitalized and are therefore no better equipped to withstand losses in the future, the new tools granted to regulators will only make bailouts more efficient – they will be institutionalized rather than authorized on an *ad hoc* basis (like TARP) or organized through the uncertain



application of the Fed's emergency authority (Bear Stearns and AIG).

In a devastating paper, the Bank for International Settlements (BIS) finds that economies of scale do not justify increases in bank size. Rather than pursuing more economically efficient arrangements, banks seem to have grown larger because of the “underpricing of risk, which might have distorted institutions’ incentives.” Growing larger allows banks to “extract rents from their market power or benefit from implicit or explicit government support.” Growing to a size at which an institution becomes “systemic” confers large benefits because creditors no longer scrutinize the firms’ borrowing in quite the same manner. If a Citigroup bankruptcy filing would be catastrophic for the global payments system, what are the chances federal officials would allow such an event to occur? Put simply, creditors are encouraged to accept lower interest rates from firms unlikely to be forced into bankruptcy.

When the normal system of market regulation does not function because of the perception of government support, or, in the case of Dodd-Frank, because a new resolution system is established for certain firms and not others, government regulation becomes even more important. The worst arrangement is one in which creditors do not provide sufficient surveillance at the same time that regulators lack the power or will to establish strict supervisory capital and liquidity standards. This was, in essence, the arrangement that governed Fannie Mae and Freddie Mac: investors would buy their debt simply because it was thought to be backed by Treasury; at the same time, regulators had no power to increase their capital standards, limit the size or regulate the composition of their investment portfolios, or establish liquidity standards to ensure they had the cash to survive long intervals without access to external finance.

There is a very real chance the global financial system could end up in a “worst of both worlds” situation where gargantuan financial institutions are permitted to increase their balance sheets, without the normal checks applied by creditors, while regulators simultaneously use fear of reduced lending to justify minimalist capital requirements. As Alan Greenspan estimated in a 2009 paper, capital requirements could be increased to 24% before having a meaningful impact on the ability of banks to profit from lending. A leverage ratio of 4-to-1 would “surely reduce the marginal lending that occurred in recent decades,” wrote Greenspan, but such lending was “in effect being subsidized by taxpayers.”

Douglas Elliott from the Brookings Institution reaches similar conclusions. The reduction in total lending is unlikely, he argues, because equity capital is not as expensive as banks suggest. When a bank goes from 20-to-1 to 10-to-1 leverage, the variance of the returns on equity declines proportionately, which means the cost of equity also declines. As shareholders’ required returns falls, stock issuance becomes less expensive because the stock is then less risky.

Congress chose to turn over the supervision of bank risk-taking from the private sector to government agencies. Given that the bill did nothing to change the incentive structure faced by large financial institutions, the basic failings of the existing regime remain intact. This increases the significance of the agencies’ role and the Basel process in the economic health of the nation and requires them both to get things exactly right, including the 243 rulemakings. That’s a high bar to get over, and the evidence thus far suggests both aren’t going to get anywhere near clearing it.