

Good Banking Regulation Needs

Clear Focus, Sensible Tools, and Political Will

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1. Historical Motivation

1.1 The Good (?) Old Days

In most countries, banking regulation was introduced or strengthened after the Great Depression, aiming to prevent bank failures from inflicting disaster on the economy again. Deposit insurance was introduced to insulate depositors from the risks that banks take, while interest rate regulation, asset allocation rules and structural separation (for example of commercial and investment banking) were meant to limit these risks.

Since the mid-1970s, important parts of this regulation have been dismantled. Some of it had become dysfunctional. For example, interest rate regulation in the US prevented commercial and savings banks from successfully competing with money market funds offering high interest rates around 1980. The requirement that Texan savings and loans institutions engage in mortgage lending in Texas exposed them to the Texan economy downturn following oil price declines in 1985, contributing to the 1986 S&L crisis in Texas.

Financial stability before 1973 was not due to good regulation but to the absence of competition in key markets and the relative stability of the environment. After 1973, financial innovation, liberalization of capital flows, and new information and communication technologies made competition more intense. Moreover risks from interest rate and exchange rate movements increased. Margins eroded and the old rules became sources of instability.

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1.2 Basel – a Panacea?

The Basel Accord of 1988 attempt to tighten regulation through international harmonization of capital requirements for credit risks; 8% of bank loans had to be funded by “loss absorbing capital” such as equity. This was subsequently refined to calibrate the requirements better to banks’ risks. To exploit their superior information, banks were allowed to use their own models for price risks of marketable securities and internal credit ratings for default risks of loans. Moral hazard from banks’ incentives to “economize” on equity by hiding risks was ignored.

The risk calibration of capital requirements, however, enabled substantial increases in banks’ reliance on borrowing, or leverage, over the past twenty years. The total assets of many European banks are over 30 times equity, and reached 100 times for Belgian-French Dexia before it was nationalized recently. Bank managers benefited because leverage raises average return on equity and thereby their compensation, but this also increased the fragility of the financial system and imposed risks on the economy.

Beyond the possibility of manipulation through internal models, risk calibration under Basel ignores important risks, for example risks of changes in interest rates that affect banks using deposits and other short term borrowing to fund long term loans. In 1980-81, US savings banks were in trouble paying 15% on deposits while receiving 6% on forty-year mortgages from the sixties, and many were technically insolvent. Yet Basel rules consider interest rate risk relevant only for the “trading book” and not for the “bank book” where most loans are held.

Basel also allows national authorities to treat government debt denominated and funded in the country’s currency as riskless. Thus, in the EU, investments in Greek or German government debt do not require any equity funding. Dexia became insolvent because its equity was insufficient to absorb losses from Greek sovereign debt considered “riskless” by capital regulation.

Similarly, “economizing” on equity can be achieved through derivatives and other financial innovations. In many bank models, credit risks hedged through credit default swaps were treated as nonexistent; counterparty risks and their correlation with the

original credit risk were overlooked. Only new equity from Singapore sovereign wealth fund and the Swiss Confederacy prevented UBS, with assets equal to 40 times equity, from being bankrupted by losses on assets that had been calibrated as “riskless.”

Basel III tightens standards for what is considered “capital” and increased capital ratios, but retains the risk weighting approach and does not address whether risks can be truly and reliably measured. The proposed leverage ratio allows total assets to be 33 times the bank’s equity.

2. Principles for Banking Regulation

A striking feature of banking regulation has been the mixing of conflicting objectives. Concerns for the safety and soundness of the system are often diluted by attempts to mobilize bank funding for worthy purposes, concern for the global competitiveness of a nation’s banks, and desire to use the industry’s professional risk management. Such mixing has led to flawed regulation. There has also been a lack of clarity about what regulation is actually doing, and whether it is cost effective in addressing its objectives.

We propose four principles of good regulation.

2.1 Safety and soundness focus

Banking regulation should have an unambiguous objective to safeguard the safety and soundness of the financial system in the public interest.

The rationale for regulating banks and other financial institutions is that their failures can have significant negative impact on the rest of the financial system and on the overall economy. One institution’s problems can spill over to other institutions, for example through contractual links, through fire sales that cause asset prices to go down, through information contagion taking one institution’s problems as an indicator of the future of others. If a significant part of the banking system is affected, the financial infrastructure of the overall economy may collapse, with potentially disastrous consequences for economic activity. The worst consequences may be avoided through government intervention, but this can be extremely costly to taxpayers.

These considerations indicate that the public interest in bank safety goes significantly beyond any interests banks themselves have in managing their risk. The sometimes high quality of bank risk management must not divert attention from recognizing that *the public and private interests regarding bank safety are not the same and might be in conflict.*

One of the studies justifying the actual Basel III “numbers” (Basel, 2010) states: “The regulatory minimum is the amount of capital needed to be regarded as a viable going concern by creditors and counterparties.” By this criterion, capital regulation would not be necessary: A bank that fails this criterion would not be viable because creditors and counterparties would refuse to deal with it. Good regulation should focus on the negative impact that undercapitalized banks impose on the rest of the financial system and on society when they are distressed. It is this external or “polluting” impact that the regulation should seek to limit.

Concerns about global competitiveness or funding of politically-favored projects should not affect banking regulation. Competitive success achieved by taking excessive risks at the expense of taxpayers is *not* in the national public interest. For example, the success of Royal Bank of Scotland in the bidding for ABN-AMRO ended up costing UK taxpayers dearly, without any compensating gain. Globally “successful” banks in Ireland and Iceland inflicted great damage on their economies.

2.2 Connecting measures and objectives

There must be a clear and realistic account of what regulatory measures can achieve and how they promote the objective of the regulation, taking account of systemic effects.

A few examples illustrate this principle.

- Restrictions on banks’ activities can add risks and generate inefficiencies if they are not properly designed. For example, if banks are restricted to investments in a particular region, this limits their ability to reduce risk through diversification.
- Structural measures, such as the Volcker Rule prohibiting proprietary trading by commercial banks in the US, and ring fencing of retail banking as proposed by the

Vickers Commission's in the UK, raise the questions of whether it is possible to insulate activities that are essential for the economy, like deposit taking, payment systems and retail lending, from investment banking risks, and whether, despite the Lehman Brothers experience, a no-bailout policy for investment banks can be maintained in a crisis.

- If reserves or equity capital are needed to satisfy regulatory requirements, they cannot actually serve as buffers (Goodhart, 2010). With capital regulation, this paradox generates a pro-cyclical mechanism where, after losses that reduce a bank's equity, assets are sold to maintain the required capital ratio, creating downward pressure on asset prices, with potentially negative effects on other banks. This problem is reduced if capital ratios are much higher and with a form of counter-cyclical provisioning, as proposed under Basel III.
- If regulation provides incentives for banks to shift risks to third parties, attention must be paid to the ability of counterparties to bear the risk. Overlooking this can give an illusion that risks are gone when they are in fact lurking elsewhere in the system.
- Liquidity regulation should recognize that liquidity is not intrinsic to assets but may change abruptly. Treating all government bonds and even certain privately issued bonds as perfectly safe and liquid is problematic.
- Resolution and "bail-in" mechanisms with vaguely defined triggers may be ineffective, because political considerations and fear of "contagion" are likely to prevent policy makers from pulling triggers in time for the mechanisms to work as intended. It is also unrealistic to expect the industry to cover the costs of resolutions in a crisis, since weakened institutions are unlikely to be able to bear the burden.

2.3 Cost effectiveness

Regulation should focus on measures that are cost effective and that do not require that supervisors know more than is feasible for them to know.

This principle militates against regulations that interfere in the details of what banks do. Since supervisors are not sufficiently steeped in these details, such interference would be ineffective and costly. Attempts to fine-tune risk weights are prone to similar problems. However, structural changes meant to reduce the size and complexity of large

global banks without interfering in day to day activities can be useful for achieving the regulatory objectives. See, for example, Hoenig and Morris (2011).

Cost-effectiveness considerations strongly favor capital requirements relative to other approaches. While liquidity and reserve requirements can help banks satisfy sudden withdrawals of funds by short-term creditors, they have a significant opportunity cost because they prevent funds from being used for lending. In contrast, there is no such cost for capital requirements, which only concern funding and not the bank's investments. Moreover, a bank with a lot of equity that can absorb losses is likely to avert liquidity and funding difficulties, because short-term creditors have more confidence in its solvency. If solvency is not a concern, providing occasional liquidity support does not impose much cost on taxpayers.

Bankers and others argue against capital regulation claiming that "equity is expensive." From the perspective of regulation, however, this objection is invalid. Increases in equity funding would raise the banks' private funding costs *only* because government subsidies to debt would be reduced (Admati et al., 2010). Such subsidies are due to explicit or implicit guarantees and to the preferential tax treatment of debt. The private costs to the banks from reducing these subsidies would be matched and surpassed by benefits to the taxpayers and the economy. Better capitalized banks are able to absorb more losses without needing additional funds and without contracting their lending due to financial distress and debt overhang.

Debt overhang also colors bankers' reaction to demands for recapitalization and to higher equity requirements. If recapitalization makes a bank's debt safer, this comes partly at the expense of existing shareholders, who might see the loss of subsidies or the need to bear more downside risks (rather than leave them to creditors or taxpayers) reflected in a lower stock price. This cost to shareholders, however is outmatched by the benefits to debt holders, taxpayers, and the economy. To the extent that the bank's shareholders are diversified, they also do not clearly benefit from the high leverage of the banks in their portfolio.

An inability to raise equity in private markets can flag a solvency concern. In this case authorities should consider whether the bank is viable or a “zombie” that should go into resolution (Onaran, 2011).

2.4 Addressing distorted incentives

It is desirable to reduce the conflict of interests between bank managers and the public with respect to risk taking by banks.

Bankers seldom if ever face significant negative consequences when they take excessive risks that endanger the bank and the broader economy. When compensation and bonuses depend on short term performance and on measures that encourage risk taking, bankers keep their past bonuses even if the bank and the economy suffer losses as a result of their investments. Regulating pay structures so that cash bonus payments are deferred and can be clawed back if losses occur is a minimum. The focus on Return on Equity in banking, discussed in P. Jenkins (2011) and R. Jenkins (2011) also feeds bankers’ objections to equity. Wolf (2010) discusses the rationale for regulating banker’s pay and some approaches.

Tax subsidies of debt encourage excessive borrowing, which creates an additional conflict between banks’ preferences regarding their funding and what is good for the public. This interferes with good banking regulation. It would be highly desirable that tax codes change to equalize the treatment of equity relative to debt funding, or even encourage more equity at least for financial institutions.

3. Political Economy and Implementation

For good regulation to be enacted, policy makers must know what it looks like and be willing to go through the requisite political process. However, good regulation has been elusive, partly because banks and governments have developed “corruptive dependencies” (see Lessig, 2011). Most governments care less about the risks banks impose on taxpayers than that banks fund favored purposes. Politicians may benefit from campaign contributions or other opportunities. In this environment, as described in

Johnson and Kwak (2010), for example, policy makers are subject to intense political pressure and lobbying.

Regulators and supervisors also come under pressure, from politicians as well as the industry. However, if regulation is to achieve its goals, it must be enforced reliably and effectively. Much of the laxness in regulation before 2007 was not due to a lack of regulatory tools but to a lack of will to use the available tools. Supervisors who are reluctant to stand in the way of the nation's champions are hardly willing to be strict in enforcement. Being subordinated to their governments, they may avoid, or be prevented from countering the bankers who are in favor with their superiors.

When political considerations enter the implementation of beneficial regulation improperly, the promotion of the public interest is compromised. To avoid this outcome, it is desirable that banking supervision should be immune from interference by the government. Subordination of supervision to the government has traditionally been justified on the grounds that taxpayer must foot the bill if banks run into difficulties. However, the symbiosis of banks and government with banks funding government-favored projects and governments bailing out banks corrupts the governance of both. Supervisory independence could perhaps break the nexus.

Even then, capture of regulators or supervisors by revolving-door recruitment or by the greater sophistication and information of bank managers remains a serious concern. One way to counteract this might be "benchmarking," i.e., creating opportunities to compare practices across supervisors of different nations or other industries. Kane (2011) discusses this problem and proposes additional approaches.

A critical question is of how much discretion supervisors should have. Ideally, it would be useful to allow supervisory judgment to address pro-cyclicality and prevent inefficient asset sales, or to adjust capital requirements depending on the assessed buildup of systemic risk through business and credit cycles. However, discretion is problematic if regulators or supervisors are captured.

The past decade does not provide grounds for optimism. Whereas Basel's "Pillar 2" rules require supervisors to exert judgment and step in if they consider banking practices

to be “unprofessional,” these rules have hardly ever been applied. Many practices of the past decade seem to fall quite clearly under this category. Examples are the substantial maturity transformation at structured investment vehicles, the very large commitments that some banks made to these vehicles, and the off-balance-sheet treatment of these commitments. Similarly, as described in Acharya et al. (2011), large US banks were allowed to continue paying generous dividends, depleting their equity and reducing their ability to absorb losses even after trouble in subprime markets was evident in summer 2007, and through the worst of the crisis. This exposed taxpayers to unnecessary risks.

To summarize, good banking regulation focuses on promoting the public interest in financial stability, gives regulators cost effective tools, and creates an environment where regulators and supervisors have both the ability and the will to use the tools to implement and enforce the regulation.

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