

THE CASE FOR SIMPLE RULES AND LIMITING THE SAFETY NET

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For the last 100 years, government officials and bank CEOs have insisted that new policies, rules, and laws—combined with greater market discipline, resolution schemes, and enhanced supervision—would ensure that future financial crises, should they occur, would be more effectively handled. In the United States, the creation of the Federal Reserve System and Federal Deposit Insurance Corporation are examples where such assurances were given to the public. More recently, the FDIC Improvement Act of 1991 and other legislation were intended to end public bailouts of failing banks and, in particular, prevent the moral hazard problem inherent in “too big to fail.” Such assurances seem even more significant following a U.S. Treasury (1991) study that found that “too big to fail” resolution policies used for six of the largest banks cost taxpayers more than \$5 billion (in current dollars). If only the cost of the six largest bailouts in this recent crisis were just \$5 billion. Unfortunately, it was many times greater.

Incentives matter and the incentives toward risk taking among the largest financial firms remain basically unchanged from pre-crisis times. Despite the enormous regulatory burdens placed on financial firms, post Dodd-Frank, these firms continue to be driven toward leverage. With time, we can be confident that our financial system

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will once again become highly leveraged and the economic system will become more fragile as a result.

To change outcomes, you must change incentives. With the safety net, you alter the market's incentives, create moral hazard, and drive toward leverage that creates its own set of adverse consequences. There are three steps that I suggest be taken to control these negative effects: (1) limit the safety net's protection, (2) simplify and strengthen capital adequacy standards, and (3) improve bank supervision. Each of these will be discussed in turn.

Limiting the Safety Net's Protection

It is important to recall that following the Great Depression, when the safety net was greatly expanded with FDIC insurance, which was in addition to the Federal Reserve's discount window, Congress and other policymakers understood that something needed to be done to control the moral hazard problem inherent in the safety net. The tradeoff was to limit FDIC insurance to commercial banks because of their importance to the payments system and the intermediation process from saver to borrower. Higher-risk investment banking and broker-dealer activities were forced out of commercial banks and away from the safety net.

For several decades, under this structure, we had relative stability within our financial system. With that stability, however, over time market participants began to say that the market would be more competitive and the consumer would be better served if investment banks and commercial banks were allowed to compete directly with one another. This was eventually allowed with the passage of the Gramm-Leach-Bliley Act of 1999, which ended Glass-Steagall.

In doing so, we may have temporarily increased competition, but we also encouraged the industry to leverage their balance sheets further using the advantages of the safety net and expanded the safety net's coverage of more risky activities. It did not take even a decade for the industry to leverage up and engage in the highly risky activities that eventually led to the crisis of 2008.

Therefore, if we are going to continue to have a financial safety net, then its coverage should be narrowed to what it was intended to cover—namely, the commercial banking industry narrowly defined (i.e., the payments system and the intermediation process). If we do not do that, then we are on our way to making these firms public

utilities, or they will be nationalized because the safety net will be at extreme risk.

We need to move the broker-dealer and trading activities out of the banks into separate corporate entities (see Hoenig and Morris 2012). With this action, we would reestablish narrower coverage of the safety net and provide greater market discipline and, in time, greater financial stability to a broad range of financial activities.

I am often told that the largest banks were not the cause of the 2008 financial crisis. Lehman Brothers is often given as an example of why this is true. I suggest Lehman was a commercial bank in every sense. It had very-short-term liabilities, such as repos, that were used to fund longer-term assets, just as banks use demand deposits. Many repos were overnight instruments and were not subject to the same rules as other liabilities should the firm fail. Furthermore, major investors in repos were money market mutual funds, which do not mark the net asset values of their shares to market. As a result, they were understood by most consumers to be deposits and were treated as deposits. As Lehman and other institutions leveraged themselves and built complexity and size around these instruments, the presumption formed that the government would protect creditors, and the moral hazard problem worsened. These investment firms leveraged up to an incredible degree and increased the vulnerabilities of the system. Moreover, I also would note that the recipients of TARP funds were mostly the largest banks in the country.

There have been no significant changes to these arrangements post Dodd-Frank, and unless the structures of these firms are simplified and they are made more accountable for their actions, we will see the same mistakes made in the future. Now is the time to act.

Simplifying and Strengthening Capital Adequacy Standards

In addition to narrowing the safety net, we must rethink the role of capital and the Basel capital standards. Basel's risk-weighted capital requirements are too complicated and too easily gamed. Basel allows banks to shrink their risk-weighted assets so that their capital ratio increases while their real leverage is extended. Under Basel I, for example, the ratio of risk-weighted assets to total assets was

around 75 percent. In 2007, Basel I risk-weighted to total assets for the largest firms averaged just over 60 percent.

When the crisis was emerging in 2007, the advertised total risk-based capital ratios of the largest banks were around 11 percent. However, their average *tangible* capital to total assets, which excludes deferred tax benefits and other intangible assets, was less than 3 percent. That is, there was less than three cents for every dollar of assets available to absorb losses. Using tangible capital, a far more meaningful measure, it becomes clearer why the crisis occurred and the industry imploded. There simply was too little capital to absorb losses, and banks had to shrink their balance sheets to survive.

We need to simplify our measure to judge the adequacy of bank capital. We need a measure that is easily calculated, understood, and enforced. The tangible capital ratio comes closest to doing this. Today, most investment managers rely on this measure of tangible capital to tell them how strong or weak a bank is.

We need to go to tangible capital as the global standard. The debate in Basel should be about the correct tangible capital level requirement and what the transition period to that level should be.

Currently, the eight global systemically important banks (G-SIBs) in the United States have a tangible equity capital ratio of about 6 percent under U.S. accounting rules, while it is just over 3.5 percent using international accounting standards. But, under either of these two accounting standards, the top 10 largest non-G-SIB banks and the 10 banks up to \$50 billion in assets have a tangible capital ratio that is around 8 percent. The 10 community banks up to \$1 billion in assets have a ratio that is over 8.5 percent. So, most banks have ratios already close to a 10 percent level. Also, if you go back to a time just before the safety net was created, the market demanded that the average equity capital to asset ratio be between 13 and 16 percent.

Again, unless we enforce meaningful capital standards for these largest financial firms, we will continue to have a system that is highly vulnerable to shock. Now is the time to act.

Improving Bank Supervision

Finally, if we hope to understand the condition of these largest banks, we need to do a better job of examining them. Today, our oversight skims only the surface. Stress tests, for example, are useful, but there are more comprehensive methods to examine the quality

of a firm's assets by sampling across their portfolios and assessing whether capital is adequate relative to risk. Also, control systems need to be checked and verified. "Trust but verify" is the supervisors' responsibility. Some sampling is done now, but if we used this tool more vigorously, we could gain considerably greater insight into the condition of these firms.

If supervisors continue rely on management's assurances alone, they also will continue to be surprised. Now is the time to act.

Conclusion

We will never end financial crises. Capitalism and fractional reserve systems are very successful systems, but they also are volatile. However, we can contain the effects of the volatility and make these firms more accountable for their actions. Simplifying and strengthening capital standards and improving supervision of the largest, most complex firms are steps in that direction. Furthermore, if we expect the market to drive outcomes, then we must narrow the safety net's coverage of liabilities and increase the ability for the market to identify and deal with these firms without the government's ever-expanding support.

References

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