What Is Meaningful Banking Reform, Why Is It So Necessary…and So Unlikely?

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The Problem

Reform or repression, that is fast becoming the choice. On the one hand, there is evidence that large, global, universal banks have played a unique and productive role as providers of financial services. It is worth preserving the unique capacities of those global banks, if possible. For example, Great Britain's Big Bang of 1986 – which not only reformed its securities trading, but also ushered in a new era of global universal banking – was not only associated with a boom in securities offerings and trading; it also produced a tripling of the ratio of bank credit to GDP from 1986 to 1990.[1] The new global universal banks offered a rich and unique array of financial services for their global corporate clients, and unique geographical reach, which made banks useful not only for credit, hedging, and securities offerings, but also for strategic advice about managing clients' financial structure and global operations.

It is just as clear, however, that unless meaningful reforms are undertaken – which result in proper risk management practices and the end of too-big-to-fail bailouts – eventually the political tide will turn against global universal banking. The social costs of bailing out global banks – especially in countries like Great Britain and Switzerland, with enormous banking systems relative to their GDP – are simply too great to be tolerated.

[1] Calomiris and Haber (2013), Chapter 5, Figure 5.4.

The crisis of 2007-2009 was the most disruptive global banking crisis since the Depression, but it was not a unique event. Over the past three decades, the world has experienced a global pandemic of banking instability. Over a hundred major banking crises have occurred worldwide, with bailout costs that average about 16% of GDP, and foregone GDP costs resulting from the recessions that coincided with those credit collapses of roughly the same amount. This is unprecedented. For example, during the prior wave of financial globalization, from 1874 to 1913, there were only five country-episodes of significant banking system insolvency in the world, with much smaller resolution costs as a share of GDP. Those episodes (in Argentina, Australia, Brazil, Italy, and Norway) reflected unusual policy choices that encouraged or subsidized banking system risk; what was rare historically has become the norm.[2]

The exceptionalism of the current era of banking instability gives cause for hope about the physical possibility of reform to succeed; it shows that banking systems are not inherently prone to disaster. But the exceptionalism of the current era also gives cause for pessimism: the new era of banking instability reflects a pervasive change in the politics of banking that will be hard to reverse.

The key political decision driving instability has been the protection of banks' liabilities by governments. Once governments protect banks – through a combination of explicit deposit insurance, lender of last resort assistance, and ad hoc bailouts – bank debtholders have little incentive to monitor banks' risks or to withhold funding as the result of increases in the riskiness of bank debts. In principle, prudential regulation, enforced by regulators and supervisors, can replace market discipline, and thereby prevent banks from taking excessive risks, by imposing

[2] Calomiris and Haber (2013), Chapter 1.

minimum capital ratio and cash ratio requirements and other prudential rules. In practice, however, regulators and supervisors generally have not proven equal to the task.

How and Why Regulatory Discipline Fails

In the decades leading up to the recent banking crisis, regulators and supervisors consistently failed in three key areas: (1) they did not measure banks' risks credibly or accurately, or set sufficient minimum equity capital buffers in accordance with those risks so that banks would be able to absorb potential portfolio losses reliably, (2) they failed to enforce even the inadequate capital requirements that they did impose because supervisors consistently failed to identify bank losses as they mounted, and thus allowed banks to overstate their levels of capital, and (3) they failed to design or enforce intervention protocols for timely resolution of the affairs of weakened banks to limit the exposure of taxpayers to protecting the liabilities of feeble, "too-big-to-fail" banks.

The failures of prudential bank regulation have been visible for decades and have motivated many regulatory reform proposals by financial economists. There are credible solutions to the key policy challenges that the government faces. For the most part, my proposed solutions to those problems are not new; they have been known and advocated by financial economists for some time. The failure to prevent the crisis was not a failure of thinking, but a failure of will on the part of our political system. Our politicians and regulators have found it expedient to offer hidden subsidies for risk taking to bankers and bank borrowers through the combination of safety net protection and ineffectual prudential regulation. Attempts to identify and rein in those subsidies have been defeated politically time and time again.

Will proposed reforms in response to the crisis this time be effective? Will reformers succeed in implementing changes in the rules of the game that would reduce the chance of a repeat of the recent crisis? The experience with post-crisis reforms in financial history offers, at best, a mixed record of responses (see Calomiris 2010, 2011a); overall, it is fair to say that there is lots of cause for pessimism for a simple reason: politicians don't really have strong incentives to solve the problems of banking regulation; they have strong incentives only to pretend to do so.

The typical post-crisis response gives the appearance of diligence, as politicians and regulators assemble a laundry list of the things that went wrong in the crisis – typically defined with reference to the specific symptoms of poor policies, not the deeper incentive problems that policy errors have produced. That laundry list then gives rise to a new, more complex set of regulatory initiatives, and these laws and rules are advertised as preventing a recurrence of the problems.

Deficiencies are supposedly remedied by ever-more complex sets of rules for measuring risk, by the granting of increased supervisory discretion to a variety of new government officials with varying mandates, by scores of new research initiatives pursued by increasingly fragmented research and supervisory divisions at central banks and supervisory agencies, by the creation of new international study groups. Is it too cynical to see this exponential increase in complexity of rules, and of the regulatory and supervisory authorities charged with designing and enforcing them, as purposely designed to reduce accountability by dividing responsibility and by making the regulatory process less comprehensible to outsiders? I don't think so.

The implicit theory behind these sorts of initiatives, to the extent that there is a theory, is that the recent crisis happened because regulatory standards were not quite complex enough, because the extensive discretionary authority of bank supervisors was not great enough, and

because rules and regulations prohibiting or discouraging specific practices were not sufficiently extensive.

That theory is demonstrably false. At the core of the recent financial crisis – and the many that preceded it around the world in the past three decades – have been basic incentive problems in the rules of the game set by the government. The pre-crisis environment was one in which regulatory complexity was unprecedented, supervisory enforcement was virtually non-existent, and private risk taking at public expense was virtually unlimited. And yet this is precisely the environment that has produced the most unstable thirty years of global banking history, and the most severe financial crisis in the United States since the Great Depression.

The need is not for more complex rules, and more supervisory discretion, but rather, for *rules that are meaningful in measuring and limiting risk, hard for market participants to circumvent, and credibly enforced by supervisors*. These qualities are best achieved by constructing *simpler* rules that are grounded in an understanding of the *incentive problems of market participants and supervisors/regulators*. At the heart of the failure of regulatory discipline has been the failure to address the basic incentive problems of market participants – which benefit by gaming the system to increase the amount of risk they take at taxpayers' expense – and supervisors and regulators – who are subject to acute short-term political pressures to keep credit flowing and long-term political pressures to favor the interests of particular borrowers and lenders.

Most recently, these influences have been clearly visible – almost comically – in the new liquidity standards proposed under the Basel III rules. Ironically, cash requirements are a centuries-old prudential tool that has been used, and continues to be used in some countries, to great effect. Rather than follow hundreds of years of countless precedents by imposing a simple

requirement that banks hold a substantial amount of cash assets (clearly and narrowly defined) in proportion to some observable quantity (e.g., total debt, total deposits, total assets, or total risk-weighted assets), the Basel Committee devised two complicated formulae for liquidity requirements. In each formula, the numerator (which defines liquid assets) includes non-cash assets, and the denominator requires judgment about the liquidity risk associated with various categories of bank liabilities. Not only does this standard have potentially undesirable adverse consequences (by discouraging bank liquidity creation), its complexity renders the enforcement of the standard opaque and therefore unaccountable. Then, in reaction to industry complaints that this ill-advised standard would have adverse consequences for the supply of lending, its implementation was postponed until 2019.

The keys to effective prudential regulatory reform are, first, recognizing the core incentive problems that encourage excessive risk taking and ineffective prudential regulation and supervision, and, second, designing reforms that are "incentive-robust" – that is, reforms that are likely not to be undermined by the self-seeking regulatory arbitrage of market participants, or the self-seeking avoidance of the recognition of problems by supervisors. The primary challenge is not devising effective ideas for reform, but rather, building a political coalition that will support the implementation of such ideas.

Some Specific Ideas

The first, overarching, reform that I would propose is a procedural one. Any economist or policy maker who puts forth a regulatory reform proposal should have to explain, within that proposed reform, why market participants will find it difficult to circumvent the reform, and why regulators and supervisors will have personal incentives to enforce it in a manner that will make

it effective. Until our conversation of regulation takes these incentive problems seriously, progress will be impossible.

I have also developed numerous specific incentive-robust reform proposals that meet these criteria. These proposals would simplify the regulatory structure, make it transparent and therefore accountable, and focus attention on the key challenges of bank risk measurement, bank capital measurement, and the timely enforcement of regulatory standards that ensure banks will continuously maintain adequate capital and cash relative to their risk (for the details of these proposals, and explanations of why they would promote effective management of risk, see Calomiris 2011b, 2012, Calomiris and Herring 2012). Rather than beginning by pretending that incentive problems on the part of market participants and regulators and supervisors do not exist (as in the Basel system), my proposals begin by taking those incentive problems seriously and trying to devise rules that are robust in spite of them.

These proposals include seven prudential reforms, which I summarize in Table 1: (1) the reform of the regulatory use of ratings that would quantify the meaning of debt ratings and hold nationally recognized statistical rating organizations (NRSROs) accountable financially for egregious inaccuracy in forecasting the probability of default of rated debts; (2) the use of observable loan interest rate spreads as forecasts of non-performing loans for purposes of budgeting capital to absorb loan default risk; (3) the establishment of a transparent and simple contingent capital (CoCo) requirement that incentivizes large banks to replace lost capital in a timely way (rather than disguise losses and avoid replacing lost capital); (4) the setting of simple cash requirements for banks (this would not resemble the complicated and poorly conceived new "liquidity" requirements created by the Basel III process); (5) the creation of a simple macro-prudential rule to govern the variation in capital requirements over time, which would trigger

changes only under clearly extreme circumstances, based on objective, observable criteria; (6) a reform of resolution procedures for large financial institutions that would require a pre-specified minimum "haircut" on unsecured creditors whenever the resolution authority employs taxpayer funds in the resolution (i.e., whenever there is a departure from the enforcement of strict priority in the resolution process); and (7) the establishment, as part of the "living wills" of global financial institutions that govern their prospective resolution, of clearly demarcated lines of legal and regulatory jurisdiction ("ring fencing") over the disposition of all the assets and liabilities within a bank.

This program of reform would be effective in addressing the real challenges that have threatened our financial system for decades, and continue to threaten it. Indeed, as discussed in Calomiris (2011b, 2012) and Calomiris and Herring (2012), if these standards had been in place prior to the recent crisis, it is highly unlikely that the crisis of 2007-2009 would have produced widespread banking distress or the collapse of interbank markets. If the high contractual interest rates of subprime mortgages had been used to gauge their risks (rather than the optimistic risk models of bankers) much more capital would have been required of subprime mortgages. If ratings agencies rating CDOs and subprime CDS had faced strong incentives to be honest in their appraisal of risk, then the bank capital required against those holdings would also have been much higher. If the proposed CoCos requirement had been in place, banks would have restored much more of their lost capital long before the collapse of September 2008. Higher cash reserve requirements, combined with higher capital resulting from the CoCos requirement, would have improved risk management prior to the crisis, and would have avoided the extreme problems of counterparty risk and market illiquidity that plagued the system after Lehman's collapse in 2008.

That is not to say that any of these seven specific ideas is perfect. Each of them, in isolation, works imperfectly, and will not always fully achieve its desired outcomes. That can be said of all rules – especially simple ones. The combination of these simple and credible reforms, however, will be very unlikely to fail to achieve its overarching goal of improved risk management, as the individual rules will act together as a sort of "belt and suspenders" for prudential risk management. At a minimum, it is clear that these proposals, taken together, would constitute a substantial improvement over the current hopelessly complex and ineffectual prudential regulatory system.

It is also beyond doubt that there are ways to improve upon and add to this list of seven ideas. One idea that I think is particularly deserving of detailed examination is to require that different lines of bank business (e.g., trading) be placed in separate subsidiaries, and that these subsidiaries be required to satisfy separate prudential and corporate governance standards, in addition to those imposed on the parent bank. Furthermore, for a trading subsidiary, it would be beneficial to subject it to *margin requirements* that are sufficient to ensure that it cannot produce losses that could substantially affect the parent institution (see the related discussion in Acharya, Adler and Richardson 2012).

A credible approach to reform not only would limit banking distress, it also would avoid much of the collateral damage to banking business that comes from the many hundreds of pages of complex, costly and misguided mandates that typically substitute for credible reform. Furthermore, because this approach would be effective, it would succeed in forestalling the destruction of global universal banking. As I argued at the beginning of this essay, ultimately, risk management in the banking system either will be subjected to real reform, or financial repression will inevitably result as a means of avoiding the insuperable costs of bailouts.

Unfortunately, I am not optimistic about the prospects for meaningful reform. Politically powerful market participants (borrowers and lenders) are short-sighted – more interested in the next few years of benefits they can extract than in the long-term efficiency of the banking system. Politicians almost universally hate simple regulatory criteria, based on observable measures, precisely because such regulatory standards work by removing the discretionary control that politicians, bankers, and regulators enjoy, and abuse, over the enforcement of regulatory standards. Overcoming these political challenges will require more than good economic thinking; real political leadership, guided by politicians who possess sufficient character and courage to place long-term national interests ahead of short-term political convenience, will be needed. Such individuals are in short supply. And postponing reforms even for a few years (in the interest of aiding global economic recovery) substantially increases the risk that financial repression, rather than reform, will be the long-term solution to our banking system problems.

Table 1: A Program for Incentive-Robust Regulatory Reform

1. Use observable "total loan cost spreads" (which combine information from loan interest rates and amortized loan fees) to measure the risk weights applied to loans when setting minimum capital requirements on those loans. For loans with initial "teaser" rates, the maximum loan spread during the life of the loan would be used to measure risk.

2. Reform the use of credit ratings of debt instruments to require NRSROs to predict the probability of default, rather than give letter grades, and hold NRSROs accountable for accuracy using "sit outs." Specifically, for each class of rated debt (e.g., credit card securitized debts) BBB would be defined as an estimate of a 2% 5-year PD, and A as an estimate of a 1% 5-year PD. If a 5-year moving average of actual PD for the rated BBB instruments in this class exceeds 4%, then the NRSRO will have a six-month "sit out" in rating that class of debts. If a 5-year moving average of actual PD for the rated A instruments in this class exceeds 2%, then the NRSRO will have a six-month "sit out" in rating that class of debts.

3. Establish a minimum uninsured CoCo requirement for large banks (a specially designed class of debt called contingent capital), which improves risk management and capital raising incentives. If designed properly (with sufficient conversion dilution risk), CoCos would incentivize timely recapitalization of bank to avoid dilutive conversion of CoCos. A combination of common equity and a CoCo requirement can achieve more than a common equity requirement alone, and at a lower social cost. The CoCo requirement would: (1) set a high, and observable, market-based trigger (voluntary equity issuance would occur above the trigger, which would be far above the bank failure point); (2) conversion would be dilutive (to encourage banks to avoid triggering conversion through the voluntary issuance of equity to replace lost capital); (3) the required amount of CoCos issued by banks would be large (sufficient to encourage banks to avoid dilution through the alternative of voluntary issuance); and (4) qualified CoCo holders would be restricted to non-bank institutional investors.

4. Require banks to maintain cash reserves greater than 20% of outstanding liabilities (excluding capital), remunerated at the treasury bill rate. These reserves must be held at their central bank on a continuous basis.

5. Vary capital required over time using a simple dual threshold model of credit growth and asset price growth. When both annual banking system credit growth, and either annual stock price or real estate price growth, exceed pre-established limits, raise minimum capital ratio requirements on banks by a pre-specified amount. Regulators would not be required to do so unconditionally, but would face an "enforce or explain" mandate to do so. Similarly, in recessions, capital standards would be temporarily relaxed by a pre-specified amount, for a pre-specified period, also subject to an "enforce or explain" mandate.

6. Establish a clearly stated division of responsibilities internationally in the resolution of bank operations, assets and liabilities. This entails an agreement among regulatory authorities internationally as to which country will have authority to resolve which subsidiaries, branches, and corporate entities. This implies a clear division of responsibility with respect to the disposition of all assets and liabilities.

7. All bank debts that are not explicitly insured by a government agency are subject to a bailout limit. Specifically, if a government provides resources in support of any uninsured debtholders, those debtholders must bear a minimum 10% "haircut," implying a loss of at least 10% of the face value of the debt.

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