

Handicapping Financial Reform

Will President Trump and new Fed chair Jerome Powell share an ambitious vision of reform?

◆ BY CHARLES W. CALOMIRIS

What are the key shortcomings in the current financial regulatory structure, and which reforms will be adopted to address them in the next two years? I admit that I don't know the answer to that second, more important, question. But I can explain why the stakes are high and how successful reform might be achieved.

WHY IS REFORM NECESSARY?

The point of financial regulation is to make the financial system healthy and strong so that it can promote growth, wealth creation, and stability in the real economy. From that perspective, recent regulation has been a flop. For example, many banks in North Carolina closed in the last decade—not just during the 2007–2008 financial crisis, but after the Dodd–Frank Act reforms that were intended to prevent a similar crisis in the future.

More generally, we see a declining market share for small banks, a lack of entry into banking, persistently low market-to-book values for banks (though they are starting to improve), higher charges for customers (service fees are up 111% since Dodd–Frank), weak loan growth for small and medium-sized businesses during the recovery, millions more unbanked Americans, and declines in credit card accounts of about 15%. One particularly startling development: many large banks for the first time in history have refused deposits because they are too costly for them to maintain on their balance sheets.

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Scores of academic studies have convincingly shown that these problems are attributable to regulatory policy. I am editing a special issue of the *Journal of Financial Intermediation* that contains eight new studies by academics and researchers within the Federal Reserve System and the Office for Financial Research. They show how regulation has produced these and other costs and unintended consequences for the financial system and the economy.

One important unwitting consequence has been the growth of “shadow banking”: unregulated intermediaries that substitute for regulated banks. While it is not clear that shadow banking is a bad thing per se, that growth reduces the effectiveness of regulation because it removes financial activity from regulated intermediaries. And it is clear that the growth of shadow banking has been driven by the costs of new regulations. For example, high-risk credit card customers fled to non-bank providers of consumer credit when the regulation of risk pricing by credit card banks prevented them from offering cards to risky customers. When the Financial Stability Oversight Council (FSOC)—a creation of Dodd–Frank—limited large banks' ability to supply “leveraged loans” in support of private equity deals in an attempt to prevent such lending, non-banks took over that business dollar-for-dollar, rendering the FSOC's efforts futile. Such examples abound.

Is it possible to argue that Dodd–Frank reforms create benefits that justify these costs and other unintended consequences? Have we established new rules that will prevent destructive crises from occurring again? No. In fact, one of my primary themes is that the failings of regulation have not just been high costs; we also are not getting much in the way of benefits in exchange for those costs. In particular, we have not solved the systemic risk problems we should have solved because we have failed to enact policies that will credibly reduce the chance of a recurrence of a major financial crisis.

There were two key regulatory structure shortcomings that



President Donald Trump and new Federal Reserve Board chairman Jerome Powell.

drove the 2007–2008 financial crisis: government subsidization of housing finance risk and inadequate prudential regulations (especially capital regulations that failed to keep banks far away from the insolvency point by maintaining adequate capital buffers). Despite the hundreds of major new regulations and the enormous new complexity and compliance costs, these two key problems have not been fixed.

It is true that banks currently fund themselves more by equity than before and they hold more cash assets than before. But those facts say little about the resiliency of the banking system. The relevant question is, the next time we have a recession and a major asset price correction, will banks reliably find themselves with adequate capital buffers and cash assets? In my view, the answer to that question remains no.

QM AND QRM STANDARDS AND GSE AND FHA REGULATION

The Dodd–Frank Act required the development of new regulatory standards for mortgages. Those standards were the legislator’s only attempt to deal with the problem of destabilizing government subsidization of mortgage risk, which was at the heart of the financial crisis. Note that the government-sponsored

enterprises (GSEs) Fannie Mae and Freddie Mac failed and were put into conservatorship in September 2008, but their status was not changed by any reforms since then.

Two new mortgage standards were envisioned by Dodd–Frank to keep mortgages from becoming too risky again. First, lenders issuing qualified mortgages (QM) would be given a “safe harbor” from liability under the Truth-in-Lending Act as amended by Dodd–Frank. This was meant both to discourage the origination of risky mortgages as well as to help less sophisticated consumers identify low-risk mortgages (as defined by regulators).

Second, the “qualified residential mortgage” (QRM) was created as part of a broader rule on credit risk retention (also known as “skin in the game”). Credit risk retention was intended to discourage the securitizers of mortgage-backed securities (MBS) from misleading investors by including excessively risky mortgages in the asset pools backing the securities. It was supposed to do so by requiring securitizers to retain a significant unhedged interest in the credit risk related to the securities’ underlying assets, thereby giving securitizers a strong incentive to be mindful of the risks. It

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was also intended to benefit unsophisticated consumers by reducing the incentives for the mortgage originators to offer excessively risky mortgages. Dodd-Frank specified that securitizers retain at least 5% of the mortgage asset pool, but mortgages that fit the definition of a QRM were exempted from the 5% requirement.

Further ensuring MBS securitizers' ability to avoid retaining credit risk, all mortgages bought by the Federal Housing Administration (FHA) or by the housing GSEs were automatically considered QM- and QRM-compliant, no matter what their characteristics. The QM and QRM standards therefore created a huge opportunity for the FHA and the housing GSEs to dominate the mortgage market because only they could avoid the legal barriers and economic risks associated with purchasing mortgages that would not otherwise meet the QM or QRM standards.

As if the FHA/GSE exemption were not enough to neutralize any effect from the QM and QRM standards, the agencies tasked with setting these standards caved in to heavy lobbying by the so-called Coalition for Sensible Housing Policy, which consisted of housing industry groups, mortgage brokerage groups, and urban activist groups that were opposed to limiting government subsidies for mortgage risk. The process by which the debasement of the QM and QRM standards took place has been described by New York University political scientists Sanford Gordon and Howard Rosenthal as follows:

As rulemaking proceeded, the central policy issues boiled down to whether a down payment requirement would be included in the QRM standard and, to a lesser degree, the maximum debt-to-income ratios for borrowers. In the end, the regulators caved and aligned QRM with the more relaxed standards [the Consumer Financial Protection Bureau] had crafted for QM—eliminating the down payment requirement altogether and raising the debt-to-income ratio maximum to 43 percent.

Even former congressman Barney Frank, the House sponsor of Dodd-Frank, ended up lamenting the undoing of credit risk retention and quality standards through the relaxed QM and QRM standards and the GSE exemption, which he described as “the loophole that ate the standard.”

Around the same time that the Coalition for Sensible Housing Policy was undermining the QM and QRM standards, then-president Barack Obama replaced Edward DeMarco, the prudent and courageous head of the GSEs' regulator, the Federal Housing Finance Agency (FHFA), with former congressman Mel Watt. Immediately upon assuming authority, Watt reduced the down payment limit on GSE-eligible mortgages from 5% to 3%.

The GSEs remain in conservatorship and the combination of QM and QRM rules and exemptions, lax FHFA standards, relaxation of FHA mortgage insurance premia, and continuing government funding of the GSEs, along with the operations of the FHA and the Veterans Administration's housing finance program, continue to ensure the government's control of housing finance and heavy subsidization of housing finance risk.

The government-resumed push for risky housing finance since 2013 already has resulted in an escalation of mortgage risk. At the end of July 2017, 32% of first-time buyers had debt service-to-income ratios in excess of the QM limit of 43%, which is 8 percentage points higher than it was less than three years earlier. Fannie Mae, Freddie Mac, the FHA, and the VA all hold riskier mortgage portfolios than banks, and they account for about 96% of purchased mortgage volume.

CAPITAL REGULATION

What about capital regulation? Let me remind you that in December 2008, when it was kaput, Citigroup had a very high regulatory capital ratio of 12%, but at the same time Citigroup's market value of equity relative to its market value of assets (MVE/MVA) was below 2%, reflecting the market perception that it was insolvent.

Citi's MVE/MVA had been 13% in early-2006, but it declined fairly steadily over a two-and-a-half-year period. By September 2008, Citi's and several other banks' perceived insolvency made it impossible for them to roll over their short-term debts, resulting in a systemic crisis. It wasn't Lehman Brothers' headline-generating collapse that caused the financial crisis, as is commonly assumed; Lehman was a match in a tinder box of high counterparty risk. If banks had maintained high MVE/MVA, Lehman's failure would not have produced a systemic collapse.

There is no question that capital regulation of banks has become stricter since the crisis. But the new capital regulation has done nothing to prevent a recurrence of a collapse in the economic values of bank equity alongside the maintaining of the book values of equity. The doubling down on book value capital regulation by U.S. regulators and the international Basel Committee ignores the problem and constitutes a strange attempt to make sure that every bank will be just as safe and sound as Citi was in December 2008.

Requiring some amount of book value of equity relative to assets doesn't work for several reasons: asset loss recognition by supervisors is often delayed on purpose (a practice known as forbearance); risk weighting of assets at the time of origination is manipulated by banks to exaggerate their capital ratios; and—most importantly—banks are service companies, not balance sheets: their economic value reflects forecastable changes in their cash flows, not their tangible net worth. For example, when Citi and other big banks' stock prices plummeted between 2007 and 2009, that reflected market perceptions not only of losses on tangible assets (such as MBS and loans), but also of reduced positive cash flows unrelated to assets on the books, without commensurate declines in expenses. Banks maintain branches to attract low interest paying deposits. But in a low interest rate environment in which all deposits pay nearly 0%, branches merely add cost, which is reflected in a hit to the market values of assets and equity. Similarly, revenues from various fees (for example, for mortgage servicing) also contributed to the declining value of bank equity.

Research that I have done with my Columbia Business School colleague Doron Nissim shows that forecastable changes in bank cash flows—often unrelated to changes in the values of tangible

assets and liabilities—drive collapses in the market value of equity relative to the book value of equity (MVE/BVE). These changes in cash flows occurred during the crisis for understandable economic reasons, and it is likely that similar patterns will recur in a future downturn that coincides with major asset price declines. It follows that what is needed alongside book value regulation is to make it impossible for banks and bank regulators to once again stand by for two years pretending that economic value has not disappeared even when it obviously has.

Along with many other financial economists, including Richard Herring at Wharton and former SEC chief economist Mark Flannery, I have been arguing in support of preventing a recurrence of the recent crisis by linking prudential regulation to the economic value of bank equity. The basic idea is to create strong incentives for banks to maintain a meaningful equity buffer by creating an “equity thermostat” that prods them to raise equity in the market whenever a medium-term moving average of their MVE/MVA falls below a threshold, say 10%.

This approach has other desirable features. It would permit us to reduce regulatory costs by simplifying prudential regulation in several respects. It would make regulation more transparent and accountable. And it would reward banks that are relatively efficient creators of economic value. In the past several years, some of the large U.S. banks have maintained MVE/MBE more than double their peers, but prudential regulation does nothing to recognize or reward their higher levels of economic value creation and consequent stability.

What about the new forward-looking stress tests that large banks face under Dodd–Frank? Do they ensure that banks will maintain their true economic value of equity relative to assets? No, stress tests are largely an exercise in measuring prospective shocks to the values of tangible assets, and success is measured in terms of exiting the shock with a high book value of equity-to-assets ratio.

What about Dodd–Frank’s Title II and its new resolution powers given to the Federal Deposit Insurance Corporation? Won’t those prevent disruptive failures of banks in the future, as advertised? No, Title II is not a workable or credible means of speedy resolution. Furthermore, it institutionalizes too-big-to-fail bailouts by providing a road map for how bailouts will occur and how they will be funded if orderly liquidation turns out to be infeasible, as it almost surely will.

In summary, the crisis taught us that we need to stop subsidizing risky mortgages and that we need to require banks to maintain significant capital ratios measured in economic—not just book—value. From the perspective of these lessons that should have been learned, Dodd–Frank gets an “F.” Its failure is not just the high compliance costs that it has produced, but also its not solving the two key problems it should have addressed.

SHOULD REFORM’S FAILURE BE A SURPRISE?

What have we learned from history about how to manage suc-

cessful reforms? First and foremost, we have learned not to be surprised by failure. Failures of post-crisis reforms have been the rule. The United States consistently has been the most crisis-prone economy in the world for the past 200 years. Major banking crises have occurred 17 times in U.S. history, and in many cases those crises produced ambitious reforms intended to fix the purported problems that produced the crises. For example, major prudential legislation after the banking crises of the 1980s (in 1989 and 1991) promised to fix inadequacies in capital regulation, but failed to do so.

The explanation for failure of reform is explored in my 2014 book with Stephen Haber, *Fragile by Design*. We develop a framework for thinking about what we call the Game of Bank Bargains, which explains how political actors shape financial regulatory outcomes and why winning political coalitions sometimes allow banking systems to be predictably unstable. We examine the histories of bank regulatory change in five countries, including the United States. We show that reforms fail because typically the same political coalition that had created the regulations that produced a crisis remain in charge of fixing things after the crisis.

That is a discouraging insight. If political coalitions are blocking desirable reform, is it all hopeless? Where are we today? What is the *realpolitik* that we need to bear in mind when thinking about crafting reform? Below are three key aspects of the current political environment that are particularly relevant going forward.

Banking ain’t aluminum / Simplistic political theories of regulation tend to see regulated industries as the primary architects of their own regulation. The argument is simple: industry interests—say, aluminum producers—are willing to spend more time and money organizing themselves to influence regulation than consumers are willing to spend on such efforts. The effects on consumers from bad aluminum regulation are too diffuse for any of them to spend time and money lobbying on aluminum-related issues. So the industry controls its regulation.

However, history shows that this is not the right model for banking regulation, especially in a populist democracy like the United States. Part of the winning political coalition that shapes U.S. banking regulation has always been some subset of bank borrowers. Unlike aluminum consumers, bank borrowers actively organize and lobby for regulations that favor them. Agricultural land owners did so in the 19th and early 20th centuries, and so have activist urban groups in the late 20th and early 21st centuries.

Lesson #1: If a reformer ignores powerful borrower groups when crafting reforms, those reforms will fail.

Populism matters / Bank regulation usually is not on the minds of voters, but it is after a crisis. Post-crisis resentment of bankers was at a peak after 2008 and remains surprisingly strong.

Lesson #2: It will not be possible to institute changes in regulation that are perceived by voters as soft on bankers without creating a significant political backlash.

Congress and the president aren't the only decisionmakers / For better or worse, the rise of the administrative state over the past 130 years—and especially the increase in the discretionary power of financial regulators over the past two decades—has meant that most of the decisionmaking about regulation now occurs outside of legislation.

Note that the Dodd-Frank legislation did not specify the prudential capital requirements that I was complaining about earlier; Dodd-Frank delegated the task of setting those rules to regulators, especially the Federal Reserve. The Consumer Financial Protection Bureau (CFPB), created by Dodd-Frank, does not rely on congressional appropriations to pay its expenses. It spends whatever it pleases and is funded by the Fed without limit. The FSOC can shut down any financial firm in the United States that it deems to be a threat to the financial system. The FHFA regulates the housing GSEs and can unilaterally set new binding standards for mortgage risk. These agencies and many others wield enormous power without having to seek approval for their rules or actions from Congress or the executive branch.

I hasten to point out that this is not the system of government the Founders intended. In *Federalist* #47 James Madison wrote, “The accumulation of all powers, legislative, executive, and judiciary, in the same hands ... may justly be pronounced the very *definition* of tyranny.” The powerful administrative agencies create complex regulations on the basis of vague legislative mandates, they have the power to enforce their rules, they often run the tribunals to which one must turn to protest their rules, and they also fund themselves with fees or other sources of income that do not require congressional approval.

Furthermore, their power has grown recently, as they have increasingly employed discretionary “guidance” rather than formal rulemaking as the means of regulating the financial system. Formal rulemaking must adhere to procedural standards for the consideration of comments and to the clear standards laid out in the 1946 Administrative Procedures Act. Guidance, in contrast, requires no rulemaking, solicits no comments, entails no hearings, avoids defining violations, specifies no procedures for ascertaining violations, and defines no penalties that will be applied for failure to heed the guidance. This affords regulators great flexibility. Regulatory guidance can be extremely vague, effectively allowing regulators to determine what violates compliance standards after the fact. This invites abuse of regulatory power.

That is especially true in the banking system where the law requires communications between regulators and banks to remain confidential; banks often aren't permitted to share the content of supervisors' comments with outsiders. Regulators employing guidance can avoid public statements explicitly requiring banks

to do something, but can privately threaten banks with an array of instruments of torture that would have impressed Galileo, using secrecy to avoid accountability. This is not a hypothetical problem for financial regulation, but a clear and visible one exemplified by several important recent abuses of guidance.

There is, however, a positive side to the burgeoning power of administrative agencies over the financial system, which I take to be *Lesson #3: In our current paralyzed political environment, where deep changes in regulation produced by legislation seem unlikely, changing the leadership and thinking at the administrative agencies offers an alternative to legislation as a means of achieving reforms.* Note, however, that as the aforementioned Gordon-Rosenthal study of QM and QRM standards shows, administrative agencies are not immune to

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political pressure; any reforms instituted through administrative agencies must recognize the importance of the first two lessons (the power of organized borrower groups and the widespread public resentment of Wall Street).

Why do I say that legislative action to achieve meaningful financial reform is currently unlikely? Recall that the House Financial Services Committee drafted an ambitious bill—the CHOICE Act—that, while imperfect in many respects, identifies and addresses many of the fundamental challenges that need to be faced. It passed the House but was dead on arrival in the Senate, where 60 votes are needed for passage. There is no interest by Senate Democrats in most of the reforms identified in the CHOICE Act, and little interest by some Senate Republicans.

The hard-working, thoughtful chairman of the House Financial Services Committee, Jeb Hensarling, is not seeking reelection this year. I take that as a pretty strong endorsement of my view that legislative reform of bank regulation is not currently on the menu. Furthermore, the Trump administration's Treasury Department drafted its own much more modest proposals for banking reform. They focus mainly on reducing some regulatory costs, but this too seems to have insufficient support in the Senate, where it was attacked as a gift to Wall Street.

A bill proposing a modest regulatory reform (raising the asset threshold for stress tests and other regulatory scrutiny from \$50 billion to \$250 billion) recently cleared the Senate Banking Committee. But the meager ambition of that bill confirms my view that deep regulatory reform is not feasible in the Senate.

THE PATH TO REFORM

In light of the three lessons about current political obstacles to reform, what are the prospects for reform over the next two years? If President Trump were interested in reform, what could he do, and through what means?

I am optimistic about what can be accomplished if Trump and the new Fed chair, Jerome Powell, both share an ambitious vision of reform. Call this “contingent optimism.” I don’t know if they do share such a vision, but together they could accomplish a great deal.

The most important reasons for contingent optimism are the empty seats around the table at the Federal Reserve Board, as well as President Trump’s recent appointment of Randall Quarles as the Fed governor with central responsibility over financial reform. Quarles is viewed by some as a bit of a get-along-to-go-along establishment Republican, but recently he expressed interest in a top-to-bottom review of regulation. If President Trump were to appoint others to the Fed and FDIC boards that support an agenda of reform, much could be achieved.

The Fed Board could simplify and reform liquidity and capital requirements, and make capital standards take into account the economic value of capital. The Fed could redesign stress tests for banks to be more transparent and more meaningfully based on cash flow performance. The Fed could move away from its reliance on guidance in favor of formal rulemaking, which would reduce regulatory risk. The Fed could institute a more systematic and transparent framework for monetary policy. The Fed, in alliance with the Treasury, could ensure that FSOC macro-prudential policies conform to a systematic framework. All of these changes would constitute an enormous improvement.

Not only could Powell and new governors change the Fed directly through their leadership, but he also wields substantial power through his appointments of senior staff at the Fed Board. Powell could appoint senior reform-minded financial economists to head up the staff’s efforts, and bring in a reform-minded legal scholar (someone like Harvard’s Hal Scott) to rewrite rules. A shakeup of the Board staff that would support serious reforms would be crucial, given the importance of the staff in shaping the information the Fed governors receive and their role in the practical execution of Board policies.

The president could do more. The CFPB has been pursuing a deeply politicized and divisive policymaking strategy, crafted by its former head, Richard Cordray. Now that Cordray is out, Trump could improve CFPB policies by appointing a new head that would realize its important mission: informing consumers and protecting them from unfair practices.

President Trump will also be able to replace Watt at the FHFA in January 2019 with someone who would lower loan-to-value limits of GSE mortgages back to 95%. That would rein in the mortgage risk explosion that began four years ago.

The political constraints I labeled before as the first two political lessons for reform, paradoxically, could be helpful by *pushing*

reform to be more ambitious and balanced. I see the political energy coming from the populist resentment of banks and the power of the housing interests as potentially helpful drivers of regulation. The reason is simple: only a Grand Bargain that takes into account political interests can possibly succeed and lead to sustainable improvements.

Changes in Fed or other financial regulatory policies that seek only to cut the costs of regulation will be hard to sustain in the current political environment. But an approach that cuts costs while also simplifying regulation and strengthening it in important ways to make capital regulation more credible could win support from quarters that otherwise would oppose it.

Similarly, even progress on housing policy through traditional legislative means may be possible if it is sufficiently ambitious. Legislation that seeks only to rein in mortgage risk subsidies (such as closing the GSEs) likely would not be feasible politically, but such actions would be more likely to succeed if they were combined with other policies that provide better means to the same ends—for example, means-tested down payment matching for low-income first-time homebuyers (a policy that works well outside the United States to promote homeownership without promoting mortgage risk).

In other words, I believe that the most successful, sustainable path for regulatory reform is one that doesn’t just focus on deregulation or regulatory costs, but one that also seeks to strengthen some regulations. A broader reform agenda that seeks the right kind of bipartisan logrolling might work better than a narrow deregulating agenda.

Perhaps I am an incorrigible optimist, but I believe that if the president and the new Fed chair are interested, there are important reform opportunities at hand. I believe they would succeed best by presenting a reform agenda that strengthens capital regulation while simplifying it, that relies on pro-reform appointments at the Fed Board and other powerful administrative agencies to achieve most of their immediate goals, and that identifies new ideas for bipartisan legislation on housing reform that would take into account a broad range of constituencies. With the right vision and leadership from the top, much is possible. R

READINGS

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