Beyond Basel and the Dodd-Frank Bill

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Shadow Open Market Committee
October 12, 2010

Recently, the U.S. government passed a major financial regulatory overhaul known as the Dodd-Frank bill. Soon thereafter, the Basel Committee revised its capital standards to boost minimum tier one equity requirements for banks over time.

The stated purpose of the US's Dodd-Frank financial regulatory reform bill, and the Basel reforms, was to fix the problems that came to light during the recent financial crisis. Do these reforms address those problems? Three factors were particularly important in contributing to the subprime financial crisis:

- Loose monetary policy and global imbalances kept US interest rates extremely low from 2002 to 2005, producing abundant credit and the under-pricing of risk.
- A long list of government-supported housing finance policies by Fannie Mae, Freddie Mac, the Federal Housing Administration and other government instrumentalities subsidized mortgage credit risk by relaxing mortgage leverage and underwriting standards to encourage highly levered purchases of homes by borrowers with poor credit records and little wealth (the government-encouraged standard became an undocumented mortgage with a 3% down payment).
- The combination of predictable government protection of banks (via deposit insurance and too-big-to-fail bailouts) led financial institutions to be too complacent about risk management. Meanwhile, the failures of prudential standards to measure and constrain risk-taking permitted complacent banks to expose themselves to underpriced mortgage risks without maintaining equity capital buffers commensurate with the high risk they were bearing.

The first factor was a necessary but not sufficient condition for the financial crisis; both government sins of commission in the mortgage market (the second factor) and sins of omission in prudential regulation (the third factor) played crucial roles in producing a deep and lasting crisis. Logic and historical experience suggest that even in the presence of loose monetary policy and global imbalances, if the US government had not been playing the role of risky-mortgage pusher in the years leading up to the crisis, mortgage-related losses would have been cut by more than half.

Similarly, if prudential regulation had measured the outsized mortgage risks accurately on a forward-looking basis, sufficient equity capital would have been required to prevent the mortgage meltdown from creating financial meltdown.

Looking over the more than 2300 pages of text in the new financial reform legislation, what is notable is the lack of connections between these causes of the crisis and most of the legislation. The Pew Trusts Task Force on Financial Reform, of which I was a member, brought together a bipartisan group of prominent financial experts to suggest financial reforms and, in December 2009, the group issued a statement with detailed proposals for restructuring regulation and other government policies in light of the crisis. It is striking how little the recommendations of that group, or those of any other group of experts commenting on the crisis, influenced the Dodd-Frank bill.

The Pew Task Force recommendations do intersect with the new financial reform bill in some areas, notably the encouragement of derivatives clearing on exchanges, improvements in derivatives disclosure, the creation of a macro-prudential regulatory mandate to vary prudential requirements over the business cycle, the setting up of a consumer protection agency to prioritize the enforcement of financial standards to prevent abuse, and the creation of a resolution authority for non-bank financial institutions. But even in these areas of intersection, the legislation often misses the mark.

Sins of Commission

The new Dodd-Frank resolution authority vested in the Federal Deposit Insurance Corporation (FDIC) awards it unlimited bailout authority, meaning it can now insure any debt on planet Earth against any loss. A better approach would have required unsecured creditors to bear significant but bounded losses, for example, requiring that creditors suffer the same losses as they would in bankruptcy up to some maximum proportion of loss. Bounded losses can prevent systemic problems of contagion but unbounded protection of creditors institutionalizes too-big-to-fail incentive problems.

Bureaucrats in the future will likely do what they have done in the past: follow the myopic political path of least resistance during a crisis and bail out everything in sight. Knowing that, financial institutions will not take appropriate precautions. The devil, as they say, is in the detail - and the devil is certainly in the detail of the new resolution authority.

The new consumer protection agency will be housed within the Federal Reserve, although with some independent authority. The primary motivation for a new agency was to create an entity focused entirely on consumer protection, rather than the multiple mandates of the existing regulatory agencies. Placing the new agency within the Fed is contrary to that objective. Moreover, housing it in the Fed is likely to create additional problems - further politicizing the Fed and complicating its budgetary process. The new agency has an unlimited mandate, no budgetary accountability, and is not required to base its decisions on any cost-benefit analysis. This is a formula likely to produce regulatory over-reach that will reduce the supply of credit, politicize the regulatory process, and encourage bureaucratic waste.

The Dodd-Frank legislation also promotes many pet projects of its sponsors and other influential parties that have nothing to do with the recent crisis. For example, the legislation imposes hiring quotas for women and minorities in the financial services industry. It also requires new industry-funded outreach measures to encourage people on low incomes to become more involved in the financial system.

And the law's 'Volcker Rule' and derivatives trading limits place new and ill-defined boundaries on proprietary trading and derivatives positions of banks. Those limits, if enforced rigorously, will be damaging to the ability of global US banks to perform essential client services, and are unlikely to have any redeeming benefits for controlling financial system risks (see my article, 'The Volcker Rule: Unworkable and Unwise', available on the web at https://www.economics21.org/commentary/volcker-rule-unworkable-and-unwise).

Sins of Omission

The legislation does not even mention the need to fix the main policy distortions that produced the crisis, namely the many government interventions that subsidize mortgage risk-taking by homebuyers. If the US had maintained a reasonable, say, 20% minimum down payment standard in the mortgage market, as was typical prior to the recent housing binge, then the housing price decline of 2007 to 2009 could not have produced a financial crisis. Proposals to increase the minimum down payment from 3% to 5% on government-guaranteed mortgages as part of the reform legislation were rejected by Congress.

The legislation pays some lip service to other bona fide reform recommendations relating to improvements of risk measurement and capital regulation, including the improved regulation of ratings

agencies and the restructuring of capital requirements, but the implementation of the details is left to the regulatory agencies. Congress missed an opportunity to require new elements that could have made a big difference for the regulation of risk and capital standards in the financial system.

For example, many academics and some regulators favor the use of contingent capital certificates as a part of capital regulation to help overcome the too-big-to-fail problem, and many have called for fundamental reforms of the regulatory use of ratings as a means of improving risk measurement; neither of these is mandated in the legislation.

Instead, the legislation calls for studies of these (and many other) topics. Such studies, as in the past, are likely to accomplish little other than feeding the campaign coffers on Capitol Hill by inviting continuing lobbying. The regulatory agencies already possess the authority to alter capital and other prudential requirements, and are already in the process of doing so; the legislation will have little or no effect on the outcome of that process.

The small boost in equity capital requirements enacted by the Basel Committee also falls far short of the mark. The new requirements are so meek that Citibank's tier one equity ratios were far in excess of what is now required. That did not prevent Citibank from becoming insolvent, and there is no reason to believe that the new capital standards would work any better next time. And, more importantly, capital must be budgeted relative to risk; the Basel Committee has done nothing to reform its flawed means of measuring risk (using banks' internal risk models, and incentive-conflicted rating agency opinions).

What Would Work?

Now that the focus of reform has shifted from legislation to regulation, would-be reformers are looking to regulatory agencies to spearhead the needed reforms. The SEC and the Fed have significant powers already vested in them to institute meaningful reforms. Which reforms would work?

The key to an effective reform program is to take incentives seriously – both the incentives of market participants to try to avoid the costs of regulation, and the incentives of supervisors, regulators and politicians to enforce the rules that are written.

Rather than cover all the relevant areas of opportunity for regulatory reform, I will illustrate that point with four proposals for improving the structure of capital, the measurement of risk, and for reducing the likelihood of too-big-to-fail bailouts.

Use loan interest rates when measuring loan default risk. Loan interest rate spreads compensate banks for the risk of default on the loan. If U.S. regulators had followed the example of countries that use interest rate spreads to measure loan risk, they would have required substantial additional capital to be budgeted against high-interest subprime loans in 2004-2007, which would have discouraged the over-investing in housing ex ante, and would have insulated the banking system from the losses on those loans ex post.

Using the overall lifetime rate of return on a loan as the measure of risk is relatively immune from manipulation. Bankers will not cut their loan rates in order to save on capital charges. Supervisors can enforce the rule fairly easily, and there is no need for supervisory or regulatory discretion needed in determining capital. Thus, this rule has good incentive consequences for all parties.

The SEC should r*eform the use of credit ratings to require NRSROs to estimate the probability of default, and provide that number as their rating for regulatory purposes, rather than give letter grades, and then hold NRSROs accountable for the accuracy of those estimates.* Letter grades have no objective meaning, and thus, rating agencies cannot be held accountable for those letter grade ratings. If, instead, NRSROs were required to provide numbers, representing their estimates of the five-year probability of default on the debt, then regulators could construct (generous) confidence intervals for those estimates, and penalize rating agencies for grossly underestimating the probability of default. An appropriate penalty would be a "sit out" from rating those debts as an NRSRO for some period of time (say, three months) while the rating agency recalibrates its estimates. That prospective loss of fee income would provide a powerful incentive not to understate risk. To preserve the "through-the-cycle" quality of the ratings, and to avoid small-sample problems, a long-term moving average could be employed when calculating the track record of the rating agency.

Establish a minimum uninsured debt requirement for large banks in the form of a specially designed class of subordinated debt known as "CoCos," or contingent capital certificates. These CoCos would convert to equity based on observable market triggers (when the ratio of the market value of equity relative to the market value of assets falls below some pre-established threshold).

CoCos have three desirable properties: (1) Because these debtholders cannot be bailed out (debts convert into equity long before a bailout would be contemplated), the pricing of these instruments in the market will provide information to supervisors about true market perceptions of risk (as opposed to spreads on current bank debt, which may be regarded as protected). (2) During a down market, if CoCos were to convert, then the debt service of the bank would be reduced, which would stabilize banks during bad times. (3) Most importantly, if designed properly, CoCos would incentivize managers to issue new equity capital early on in the wake of loan losses in order to prevent the triggering of a CoCo conversion. The key to making this sort of voluntary equity offering happen is to make the CoCo conversion sufficiently dilutive of equity holders, so that bank management will reliably prefer the dilution from issuing new equity. If this sort of CoCo requirement had been in place prior to 2007, none of the major failed banks or investment banks in the United States or Europe would have failed; all would have had ample opportunity and incentive to recapitalize. The financial crisis would have been much less severe.

Because CoCos improve ex ante risk measurement by providing early warning of problems in a very public way, they also encourage credible supervisory discipline. Finally, because CoCos would incentivize voluntary equity offerings in the wake of losses to prevent conversion, or alternatively (if

those offerings are inadequate) reduce debt service burdens upon conversion, they would not only reduce the vulnerability of banks in down markets, they would also reduce the probability of too-big-to-fail bailouts.

Limit the extent of discretionary bailouts of creditors under Dodd-Frank. As noted above, the Dodd-Frank bill makes unlimited bailouts of creditors possible. This is a mistake that could be easily corrected by explicitly limiting the protection of creditors to no more than "x" percentage of their principal. Even if creditors knew that only 90% of their principal was protected, that would provide a powerful incentive for them to be careful about the riskiness of the banks in which they invest. By making that percentage sufficiently generous (say, 90%), the rule should be credibly enforceable, since there could be no justification for the view that permitting a 10% loss to a creditor would produce a chain reaction of cascading loss leading to a global financial meltdown.

For the sake of brevity, I will confine myself to these four recommendations. The same principles of transparency and incentive-compatibility could be employed in the construction of other reforms, including living will requirements, liquidity requirements, and macro-prudential capital requirements that vary over the cycle. Reforming prudential financial regulation to be effective is possible, but only if reforms address the two key challenges of (1) measuring risk accurately in order to budget capital accordingly, and (2) avoiding too-big-to-fail. And credible solutions must take into account the incentives that market participants, supervisors, regulators, and politicians often have to subvert poorly designed regulations.