Everything the IMF Wanted to Know About Financial Regulation and Wasn't Afraid to Ask

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I was honored when the IMF asked me to moderate the Financial Regulation panel at this year's Rethinking Macro II conference. And while naturally I delivered one of the more enlightening and thought-provoking policy discussions of the conference, I did fail in my duties as moderator to make sure my panelists covered all the excellent questions our sponsors submitted to us. Of course, this was to be expected, as panelists at these types of events almost never address the topics requested of them (I certainly never do) but rather, like presidential candidates, answer the questions they want to answer. However, being the conscientious person I am, who accepts responsibility for my mismanagement (unlike some bank CEOs we know), I will now step up and answer those questions myself.

1. Does anybody have a clear vision of the desirable financial system of the future?

Yes, me. It should be smaller, simpler, less leveraged, and more focused on meeting the credit needs of the real economy. And, oh yes, we should ban speculative use of credit default swaps from the face of the planet.

2. Is the ATM the only useful financial innovation of the last 30 years?

No. If bankers approach the business of banking as a way to provide greater value at less cost to their customers (I know—for a few bankers that might be big "if"), technology provides a virtual gold mine for product innovations. For instance, I am currently testing out a prepaid, stored-value card that lets me do virtually all my banking on my iPhone. It tracks expenses, tells me when I've blown my budget, and lets me temporarily block use of the card when my daughter, unbeknownst to me, has pulled it out of my wallet to buy the latest jeans from Aeropostale. The card, aptly called Simple, was engineered by two techies in Portland, Oregon. (Note to megabanks: Ditch the pinstripes for Dockers and flip-flops. The techies are coming for you next.)

3. Does the idea of a safe, regulated core set of activities and a less safe, less regulated noncore make sense?

No.

The idea of a safe, regulated core set of activities with access to the safety net (deposit insurance, central bank lending) and a less safe, more regulated noncore set of activities that do not under any circumstances have access to the safety net—that makes sense.

4. How do the different proposals (Volcker rule, Liikanen, Vickers) score in that respect?

Put them all together and you are two-thirds of the way there. The Volcker rule acknowledges the need for tough restrictions on speculative trading throughout the banking organization, including securities and derivatives trading in the so-called "casino bank." Liikanen and Vickers acknowledge the need to firewall insured deposits around traditional commercial banking and force market funding of higher-risk casino banking activities. Combining them would give us a much safer financial system.

But none of these proposals fully addresses the problem of excessive risk taking by nonbank financial institutions like AIG. Title I of Dodd-Frank empowers the Financial Stability Oversight Council to bring these kinds of shadow banks under prudential supervision by the Fed. Of course, that law was enacted three years ago, and for nearly two years now the regulators have promised that they will be designating shadow banks for supervisory oversight "very soon." This was repeated most recently by Treasury Secretary Jack Lew on May 22, 2013, before the Senate Banking Committee (but this time he *really* meant it). For some reason, the Fed and the Treasury Department were able to figure out that AIG and GE Capital were systemic in a nanosecond in 2008 when bailout money was at stake, but when it comes to subjecting them to more regulation now, well, hey, we need to be careful here.

5. How much do higher capital ratios actually affect the efficiency and the profitability of banks?

You don't have to be very efficient to make money by using a lot of leverage to juice profits then dump the losses on the government when things go bad. In my experience, the banks with the stronger capital ratios are the ones that are better managed, do a better job of lending, and have more sustainable profits over the long term, with the added benefit that they don't put taxpayers at risk and keep lending during economic downturns.

6. Should we go for very high capital ratios?

Yep. I've argued for a *minimum* leverage ratio of 8 percent, but I like John Vickers' 10 percent even better (and yes, he put out that newsmaking number during my panel).

7. Is there virtue in simplicity—for example, simple leverage rather than capital ratios—or will simplicity only increase regulatory arbitrage?

The late Pat Moynihan once said that there are some things only a PhD can screw up. The Basel Committee's rules for risk weighting assets are Exhibit A.

These rules are hopelessly overcomplicated. They were subject to rampant gaming and arbitrage prior to the crisis and still are. (If you don't believe me, read Senator Levin's report on the London Whale.) A simple leverage ratio should be the binding constraint, supplemented with a standardized system of risk weightings to force higher capital levels at banks that take undue risks. It is laughable to think that the leverage ratio is more susceptible to arbitrage than the current system of risk weightings, given the way risk weights were gamed prior to the crisis; for example, moving assets to the trading book, securitizing loans to get lower capital charges, wrapping high-risk collateralized debt obligations (CDOs) in credit default swap (CDS) protection to get near-zero risk charges, blindly investing in triple A securities, loading up on high-risk sovereign debt, repo financing…. Need I go on?

8. Can we realistically solve the too-big-to-fail problem?

We have to solve it. If we can't, then nationalize these behemoths and pay the people who run them the same wages as everyone else who works for the government.

9. Where do we stand on resolution processes, both at the national level and across borders?

Good progress, but not enough. Resolution authority in the United States could be operationalized now, if necessary, but it would be messy and unduly expensive for creditors. We need thicker cushions of equity at the megabanks, minimum standards for both equity and long-term debt issuances at the holding company level to facilitate the Federal Deposit Insurance Corporation's (FDIC's) single-point-of-entry strategy, and—most important—regulators who make clear that they have the guts to put a megabank into receivership. The industry says it wants to end too big to fail, but they aren't doing everything they can to make sure resolution authority works smoothly. For instance, industry groups like the International Swaps and Derivatives Association (ISDA) could greatly facilitate international resolutions by revising global standards for swap documentation to recognize the government's authority to require continued performance on derivatives contracts in a Dodd-Frank resolution.

10. Can we ever hope to measure systemic risk?

Yes. It's all about interconnectedness, which megabanks and regulators should be able to measure. Ironically, interconnectedness is encouraged by those %$#@& Basel capital rules for risk weighting assets. Lending to IBM is viewed as five times riskier than lending to Morgan Stanley. Repos among financial institutions are treated as extremely low risk, even though excessive reliance on repo funding almost brought our system down. How dumb is that?

We need to fix the capital rules. Regulators also need to focus more attention on the credit exposure reports that are required under Dodd-Frank. These reports require megabanks to identify and quantify for regulators how exposed they are to each other. Megabank failure scenarios should be factored into stress testing as well.

(Since these questions related to financial regulation, I will not opine on measuring systemic risks building as a result of loose monetary policy.)

11. Are banks in effect driving the reform process?

Sure seems that way.

12. Can regulators ever be as nimble as the regulatees?

Yes. Read Roger Martin's *Fixing the Game*.(Harvard Business Review Press 2011) Financial regulators should look to the NFL for inspiration.

13. Given the cat and mouse game between regulators and regulatees, do we have to live with regulatory uncertainty?

Simple regulations that focus on market discipline and skin-in-the-game requirements are harder to game and more adaptable to changing conditions than rules that try to dictate behavior. For instance, thick capital cushions will help ensure that whatever dumb mistakes banks may make in the future (and they will), there will be significant capacity to absorb the resulting losses. Unfortunately, the trend has been toward complex, prescriptive rules that smart banking lawyers love to exploit. The industry generally likes the prescriptive rules, because they always find a way around them, and the regulators don't keep up.

You can see that dynamic playing out now, where the securitization industry is seeking to undermine a Dodd-Frank requirement that securitizers take 5 cents of every dollar of loss on mortgages they securitize. They say risk retention is no longer required because the Consumer Bureau has promulgated mortgage lending standards. But these rules are pretty permissive (no down payment requirement and a whopping 43 percent debt-to-income ratio), and I'm sure that the Mortgage Bankers Association is already trying to figure out ways to skirt them.

Rules dictating behavior can sometimes be helpful, but forcing market participants to take the losses from their risk taking can be much more effective. One approach tells them what kinds of loans they can make. The other says that whatever kind of loans they make, they will take losses if those loans default.