Panel Discussion:

Why do we need bank regulation?

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Introduction

Hello! My name is Joe Pimbley and I work in the capital markets subsidiary of a large international bank. The opinions I express here are most certainly my own.

I am deeply interested in the new BIS rules, the details, and their implementation. As the head of the credit derivatives business for the capital markets group, I advise my bank on appropriate management of credit risk. The BIS capital rules are highly relevant to the advice I will give. I plan to listen carefully to my colleagues on this panel and to your questions and comments.

Big Picture

Having said that, I'd like to use my 5 minutes in this forum to ask questions and present a point of view that I rarely hear. As I grow older, I derive more and more satisfaction and fascination from thinking about the "big picture". How do businesses work (when they work)? How do businesses fail (when they fail)? Why do some countries prosper while others stagnate?

My "big picture" question today is: why do we need bank regulators?

Before I continue, let me say that I have nothing against regulators. Those I've met, both in my work and at conferences like this, impress me. I sometimes quote the views of regulators to my own bank management. Regulators have produced some of the best research in loan portfolio credit models. I look forward to their views on this topic.

In almost all of the credit derivative trades I attempt to execute, the analysis of my return versus the true risk is straightforward. The fundamental truth of finance is that firms must enter transactions in which they are well paid for the risks they incur. To determine if you are well paid, you must be able to measure the return (generally easy) and the risk (the harder task). Firms with superior understanding of their risk and return should prevail over those with inferior risk/return measurement and comprehension.

As I said, analyzing the true risk is typically not arduous. In real life, though, I must also determine the regulatory capital impact, regulatory "permissibility", tax consequences, accounting treatment, and legal situation. It is quite often the case that a “good trade” in terms of the right risk/return measurement will have adverse treatment under one of these “hurdles” or, just as likely, will have uncertain treatment.

There are many “good trades” that **don’t happen** due to these “unimportant” considerations. There are also many “bad trades” that **do happen** due to these considerations!

Why are the regulatory, tax, accounting and legal issues largely “unimportant”? I’ll leave that question unanswered due to time constraints. Let me say only that these are man-made, rather than real, concerns.

One of my activities over the past few years has been to create a sophisticated model for the risk of a portfolio of loans. It’s hard, challenging, lots of fun, and - frankly - an unsolved problem. The industry models are “version 1.0”. The quality of banking business execution grows with the sophistication of loan portfolio risk modeling.

BIS Not Close

The BIS regulatory capital rules have the same goal as the loan portfolio models: determine how much capital to apportion to each bank transaction. But the BIS rules are wrong. They’re way off. These rules assign little risk to unfunded commitments. They provide insufficient risk reduction for guarantees and credit risk hedges. The rules have risk weights that are ridiculous. There is no “credit” for risk diversification.

These criticisms are harsh. I’ll agree that each of these statements may appear too blatant because there’s undoubtedly a “story” or reasoned explanation for each. Further, it’s likely that each defect will soften as the regulators have more years and decades to refine their rules. But the point is they’re wrong right now.

Why are the BIS rules so bad? Well, the portfolio credit risk puzzle **is** quite difficult. More importantly, BIS regulation is unavoidably a political process. That means the end result must be simple and comprehensible to all, everybody - worldwide! - must agree, and all banks and countries must be treated “fairly” (where “fairness” is generally in the eye of the allegedly offended). That can’t work. We end up with rules that are wrong but for which there is universal agreement.

As H. L. Mencken, a famous US journalist of 50 years ago, once said “Every complex problem has a simple, easy-to-understand, wrong answer.”

So Why Have Regulators ?

Clearly, the views I’ve expressed thus far do not have popular support. If the majority accepted all that I’ve espoused, then there’d be a huge clamor to throw regulation out the window. But there is no such clamor. It’s likely many of us believe that we must have regulators. Or, at least, that our competitors must have regulators.

So what's the case for regulation? Feel free to help me here, but I believe the case is regulators exist to protect bank depositors (the typical citizen) and to prevent the collapse of the financial system. (Show picture of a run on a bank.)

With regard to protecting citizens against the loss of their deposits, why is that so difficult? I can imagine a world in which banks - unsupported by their governments - advertise their credit quality with non-government credit ratings. In the US it is quite common for citizens to choose mutual funds with different levels of risk (from triple-**A** money market funds to technology sector equity funds). It works. In fact, these citizens have taken much of their money out of the banks for this purpose.

I'm not an historian. I do remember from Milton and Rose Friedman's Free to Choose monograph that the banking industry had devised a procedure to handle "runs" on banks after the first decade of the 20th century. This procedure did not guarantee immediate and simultaneous liquidity to all depositors, but it did mitigate the risk.

Well, what about the collapse of the entire financial system? I believe the popular term is "systemic risk". Does that risk exist? If so, can regulators prevent it? And if regulators can prevent it, are they behaving in a manner that **will** prevent it?

I don't believe that "systemic risk" is real. I can't prove this belief ... not yet, at least. To be honest, I don't know what regulators and doomsayers mean by "systemic risk". Whenever a lecturer waves the "systemic risk" flag for a few minutes, he/she tends to pack it away before I can get a good look at it.

Do we mean that an unregulated bank might lend several multiples of its capital base in a country like Indonesia? Or in an industry like profit-free Internet start-ups? This country or industry would then blow up and the bank would go under. Then what? This bank failure would lead to other bank failures either since all banks have the same risks or due to some supernatural sympathy of suffering? Then there'd be no banks left to lend so that many public companies would default?

I don't know. It sounds highly implausible to me. In fact, I have a rudimentary model of this supposed "systemic risk" for derivative trades. The model result shows - obvious in hindsight - that such defaults cannot propagate from one institution to another unless firms have individual credit exposures greater than their capital bases. Even incompetent banks don't run their businesses this way.

I claim, therefore, that "systemic risk" is not real. I could be wrong. I challenge those who believe I am wrong to explain a precise mechanism for "systemic risk" and to provide a quantitative model that supports the existence of this risk. If the BIS is going to base policy with absolutely huge consequences for the worldwide banking system on the presumed existence of "systemic risk", I don't believe the industry asks too much when it requests some explanation.

The Great Depression may have been "systemic risk". We had regulators back then. There's an argument of whether the regulatory system caused the banking crisis or simply made it worse.

Perhaps the LTCM story is about "systemic risk". We had regulators then, too. In my view, the LTCM experience shows how negligent bankers can be. LTCM counterparties did not require margin haircuts. The lack of margin reduced by a small amount the collateral available to the counterparties but increased tremendously LTCM's permissible leverage/risk. Who did the Federal Reserve Board protect when it intervened in LTCM? Other hedge funds? It's highly unlikely any bank would have defaulted.

Don't Be Afraid of the Absence of Control

There are few industries in the US more highly regulated than banking. The government pays farmers to behave inefficiently. That's more fecklessness than regulation. Automobile manufacturers must conform their products to many government specifications, but they're still allowed to measure their own business risks.

The semiconductor industry is almost completely unregulated. There's plenty of volatility with good years and bad years. It's chaos. Yet nobody speaks of "systemic risk". I don't believe there's any theory that DRAM prices will go so low that all manufacturers will default and we'll have no worldwide electronics industry. Why not?

Certainly an absence of regulation will give all of us the sense that there is more uncertainty in the banking world. Free markets are uncertain and they work much better than regulated markets. Free markets reward good ideas and punish bad ideas in ways that we usually don't see.

Compromise: Use the Rating Agencies

Perhaps all this talk of de-regulation is impractical. Hopefully, though, it's only been 5 minutes of impracticality. It will take at least another 20 years before banking regulation falls away. For the present, then, I suggest a compromise that many will dislike. Yet it's simple, inexpensive, and far more reliable than proposed BIS capital rules.

Let's use public agency (*e.g.*, Standard & Poor's, Moody's Investors Service, Fitch/IBCA) credit ratings for the banks themselves as a substitute for BIS capital adequacy. Regulators would proclaim a minimum agency credit rating a bank must have to operate internationally.

The agency credit ratings analyze capital adequacy as well as all other issues (*e.g.*, operational risk, willingness to pay, sovereign risk) that bear on the safety of creditors and depositors. The agencies do not apply simple, one-size-fits-all rules that distort bank behavior. All in all, I'm confident that a study of bank defaults would find that agency credit ratings have been better predictors than BIS capital ratios.

If a bank has a double-**A** credit rating from a "good" rating agency and yet BIS rules show it has inadequate capital, which measurement would you believe? Conversely, if a bank is triple-**B** minus with strong BIS capital, what is your view of the credit quality of the bank? I'd choose the double-**A** bank for my deposits.

Summary

My goal is to get this "futility of regulation" viewpoint out on the table. I hope I've done so in a positive and constructive manner. I'm not "against" regulators. Rather, it's the regulatory scheme itself I oppose.

I really would love to see a model for "systemic risk" in the banking industry. I encourage those of you with insights I do not have to produce this model. Thank you!