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Why do we need bank regulation?

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I am an amateur on the subject of regulatory capital rules for banks. My limited understanding of this topic begins with the 1988 Basle Capital Accord and ends (or at least trails off) with the ongoing effort ("Basel II") to implement an improvement to the 1988 Capital Accord.

As a very brief history, this 1988 Accord defined minimum capital requirements for banks that wished to operate beyond their national borders. The bank regulators of all participating countries agreed that foreign banks could do business within their countries if the foreign banks satisfied the (globally agreed) capital requirements. Certainly the underlying thought that strong capitalization improved bank soundness was correct.

A key problem with the 1988 Accord, though, is that the capital rules were, in varying degrees, wrong, incomplete, or deeply flawed. For example, the rules treated (unfunded) commitments to lend as if the risk to the (bank) lender were small. Such commitments of tenor less than a year actually earned zero risk weight! Is it surprising that the "364-day commitment" became a wildly popular bank product? Further, the capital rules made numerous additional arbitrary distinctions for tenors and risk classes, did not understand guarantees or other credit risk hedges, or give any benefit for risk diversification.

Why were these BIS ("Bank for International Settlements") rules so bad? First, the portfolio credit risk puzzle **is** difficult. It's actually quite challenging to create calculations that tell a bank how much risk capital to assign to each new loan, commitment, or derivative transaction. The mathematics for these capital calculations can be highly complex and there are many assumptions one must make. For example, what should one assume for the default correlation between a German auto maker and a Japanese steel company? What is the five-year default probability of an unrated Indonesian mining concern in a joint venture with an established Canadian firm? Beyond assumptions, there are many judgments that the builder of a credit risk calculation model must make. Can one specify "correct" versus "incorrect" judgments? No.

But, again, the BIS rules were really bad. There's got to be a greater explanation than simply that the true problem is extraordinarily difficult. For better or worse, BIS regulation is unavoidably a political process. That means the end result must be simple and comprehensible to all, everybody - worldwide!

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- must agree, and all banks and countries must be treated "fairly" (where "fairness" is certainly a judgment that will be different for different parties). That can't work. We end up with rules that are wrong but for which there is universal agreement.

In the late 1990's the BIS launched the Basel II project to correct these shortcomings of the 1988 Accord. Research and implementation of Basel II has monopolized the careers of thousands upon thousands of bankers, regulators, consultants, academics, and vendors. Though it's not possible to describe this effort accurately in one sentence, I'll try anyway! Basel II wants to encourage (require?) all banks to conceptualize, measure, and manage its capital adequacy in the same uniform manner.

Do we need bank regulation?

In one respect, Basel II sounds like a good idea. If the capital rules of the 1988 Accord were wrong, why not simply create the "right mathematical model" and force all (internationally active) banks to use it? There are several feasible strategies to answer this question. I will ask another question: why do we need bank regulation at all?

Before I continue, let me say that I have nothing against regulators. Those I've met in my working life often impress me. I look forward to their answers to my question.

Again, what is the case for bank regulation? The argument is that regulators exist to protect bank depositors (the typical citizen) and to prevent the collapse of the financial system.

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.

While I'm no 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 <u>will</u> prevent it?

By "systemic risk", do we mean that an unregulated bank might lend several multiples of its capital base in a country like Russia? Or that it might lend more than its capital to an industry like satellite radio 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?

That 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 may 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 we ask too much when we request some explanation.

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

Don't be afraid of the absence of government 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 ("dynamic random-access memory") 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 (since it is so difficult to roll back government control). It will take at least another twenty years before banking regulation becomes irrelevant. 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, DBRS) 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 of solvency than BIS capital ratios.

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 – and the assumption that life needs to be regulated - that I oppose.

Further, 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