Fixing Banking – Part I

Banks are junk. Thus, a government's implicit guarantee of its banks is both risky and expensive. How do we fix that? (Suggested sub-title / deck)

Banks are junk credits. Such is one conclusion of our previous Quant Perspectives column *Are Systemically Important Banks Junk Credits?* A government's guarantee of its banks is expensive precisely because the underlying banks are junk. One way or another, the taxpayers and citizens bear the large expense of the government guarantee for banks. Yet it would be disastrous for a country to lose its payment system through the near-simultaneous failure of several large banks.

Though not a "solution" to this quandary of whether and how a government should support its banks, the obvious *premise* for a solution is that banks should have much lower dependence on the government guarantee. That is, underlying bank risk should not be "junk." To the extent that banks have very low risk of failure on a stand-alone basis, they would have low risk of government bailout.

We divide proposals for "fixing banking" into three categories: "Nibble the Edges;" "Dramatic Change Inside the Box;" and "Banking Re-Boot into Safe Mode." All three have advantages and disadvantages. The first option is easiest to implement and is the current course of global governments and regulators. Unlike this first option, the second proposal would be highly effective. While straightforward to implement, this option #2 is controversial and requires an old-fashioned political battle that could go either way. Finally, we consider the third option to be the "best answer." But being right and winning arguments are not the same thing. Convincing a majority to adopt this option #3 will be challenging. In this Part I, we discuss only the "Nibble the Edges" alternative.

Option #1: Nibble the Edges

When human organizations confront failure and must take remedial action, the prevailing attitude is often to make as few changes as possible. The failure demonstrates the imperative for change. Yet all organizations have vested interests that abhor change. The result is that such institutions grudgingly concede only the incremental modifications that will supposedly eradicate future failures.

Global governments, bank regulators, and bankers constitute the large "human organization" that must address the failure of government policy, bank regulation, and banking of 2008 to the present. True to form, this organization has enacted and proposed minimal change to banking operation. Beyond the small number of significant banks (such as *IndyMac*, *Washington Mutual*, *Lehman Brothers*, and *Laiki Bank*) that governments permitted to fail without bailouts for all creditors, almost all players remain the same. Leading politicians, regulatory heads and staff, bank executives – they're all the same people. Banks and governments still retain their *political bargain* as we described in *Banks and Political Bargains*. It is not an exaggeration to say that the only reactions to the Credit Crisis are moderately higher capital requirements, the possibility of improved bank liquidity, a potential loose and discretionary limit on simple balance sheet leverage, and central banks' administration of "stress tests." (As support, the *Basel Committee on Banking Supervision* proposes nominally constructive bank liquidity requirements at *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools*, January 2013. The article M. Auer and G. von Pfoestl, "Basel III Handbook," *Accenture*, 2012, shows the increased capital requirements from Basel II and so-called Basel 2.5 to Basel III in figures 2 and 3. Though there are many "moving parts," we quote just one aspect here: minimum Tier 1 capital increases from 4% to 6% of risk-weighted assets.)

The great advantage of "nibbling the edges" in this manner is that the changes are politically achievable. Political leaders can show that "they did something." Regulators get more apparent control over banks, larger budgets, and a longer checklist of activities. Bankers retain their lucrative careers in exchange for following a modified set of rules. It stands to reason that increasing capital requirements will lead to *some* beneficial reduction of bank default risk. Thus, this edge nibbling should have a positive near-term impact if one ignores the increased and incalculable inefficiencies of the new regulation.

The glaring disadvantage of this approach is simply that there is no real change. With the eraser at the end of the pencil, regulators are removing old capital requirement values and writing in some new and higher values. The direction is right, but there's no rhyme or reason to the old or new numbers other than what emerges from a global political agreement. As a further criticism of the solution, there is not even a cogent statement of the *problem*. That is, regulators and politicians do not state a goal of a target bank stand-alone default probability or expected loss to taxpayers. Without a clear problem statement, there can be no solution and no intelligent discussion of a solution.

In Parts II and III of this series we will describe the "Dramatic Change Inside the Box" and "Safe Mode" alternatives to "Nibble the Edges." Part II will focus on the proposal of Admati and Hellwig to require multiples of additional equity capital. Part III will explain the calls of Kotlikoff, Wolf, Kay, and many others for stark reinvention of "fractional reserve banking."

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