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PUBLIC INTEREST COMMENT

Regulatory Capital: Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies

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Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation

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INTRODUCTION

The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and advancing knowledge about the effects of regulation on society. Thus, this comment does not represent the views of any particular affected party or special interest group but examines the rule from an economic point of view and asks whether it can successfully achieve its expressed goals.

On August 20, the Federal Reserve Board, Office of Comptroller of the Currency, and Federal Deposit Insurance Corporation posted a proposed rule that would raise supplementary leverage ratio standards for large, systemically important financial institutions (SIFIs). The agencies solicited comments on a list of questions. This comment pertains primarily to question 2, "Would the proposed strengthening of the leverage ratio mitigate public-policy concerns about the regulatory treatment of banking organizations that may pose risks to the broader economy?"

The answer is that this proposal would not mitigate the risks that these organizations pose. While the proposed increase in supplementary leverage ratios is a small step in the right direction, it would not protect taxpayers from risk or eliminate the advantage of "too big to fail" that is enjoyed by SIFIs. From the perspective of taxpayers, it would be preferable to have capital standards that are sufficiently high to induce SIFIs to sell off enough of their businesses so that they fall below the SIFI status. Note that, while such a policy may be justified by agencies as necessary for meeting the goals of existing legislation, it may be more appropriate for Congress to take up such a fundamental issue as restructuring the banking system.

The rest of this comment will elaborate on the challenge posed by SIFIs. It is impossible for policy makers to credibly commit *not* to back the debts of SIFIs during a crisis. This in turn leads investors to treat the debt of SIFIs as lower in risk than that of other financial institutions. This distortion creates an uneven playing

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field and exacerbates the fragility of the financial system even as public policy seeks to minimize it. No matter how hard the regulators try to prevent a crisis from emerging at any SIFI, eventually such regulatory prevention efforts are likely to fail. Thus, it would be better to break up SIFIs now, before a crisis develops.

THE TIME-INCONSISTENCY PROBLEM

The fundamental issue involved in regulating SIFIs is the time-inconsistency problem. Time-inconsistency means that an agent may wish to commit today to do something tomorrow when in fact tomorrow the incentive to break that commitment will be too strong. If this is the case, then there is no credible way to make such a commitment. For example, someone who is addicted to smoking may not be able to credibly commit to quitting tomorrow.

In the case of banks, there is no credible way for regulators to commit to *not* bail out SIFIs in the future. The incentives that regulators face during a crisis will exert a powerful influence not to keep any such commitment.

When the banks appear to be sound, it is attractive to policymakers to issue statements to the effect that no bailouts will ever take place. Policymakers may attempt to commit to a plan where, if the banks get in trouble, then the institutions will be restructured according to prearranged procedures, such as "living wills."

Should a SIFI get in trouble, at that point the restructuring idea will appear to be fraught with danger. Regulators will prefer to opt for some sort of bailout rather than risk a potential meltdown of the financial system by undertaking an untested restructuring approach in the midst of a crisis. Regulators will be inclined to protect the creditors of a SIFI rather than allow potential domino effects to begin.

The time-inconsistency problem creates perverse incentives before there is any crisis. Creditors and counterparties are aware that the commitment not to bail out is not credible. Convinced that some banks are "too big to fail," creditors and counterparties will provide low-cost funds to such banks. This gives SIFIs an advantage in the market. In effect, large banks are subsidized because of the time-consistency problem.

TIME INCONSISTENCY IN 2008

The time-inconsistency problem was very much in evidence during the financial crisis of 2008. For example, when Lehman Brothers was allowed to fail, it became clear that the commitment not to bail out Lehman had not been credible in the market. Reserve Primary, a large money market fund, had loaded up on Lehman paper in the months prior to the failure. Apparently, Reserve Primary assumed that the regulators would resolve Lehman Brothers in a way that made its commercial paper risk free. Even though in this case the regulators kept their commitment, the time-inconsistency problem still mattered, because it affected the behavior of Reserve Primary and other creditors of Lehman.

Time-inconsistency also was prevalent in the case of Freddie Mac and Fannie Mae. Until the spring of 2008, investors bought securities of Freddie Mac and Fannie Mae at very narrow spreads (less than 20 basis points) over the yields of comparable Treasury securities. Technically, Freddie Mac and Fannie Mae were backed by only a relatively small line of credit from the Treasury of $4 billion. However, as far as investors were concerned, the US government could not credibly commit to allowing Freddie Mac and Fannie Mae to default on their debts. As losses at Freddie and Fannie began to mount, investors became uncertain. By September of 2008, the GSEs were paying higher spreads, which had widened to over 100 basis points, and the Treasury decided that the US government was likely to take on all of the obligations of those companies. They determined that this policy needed to be conveyed immediately to markets, in order to reverse the widening of the interest-rate spreads that Freddie and Fannie were faced with. Thus, the two agencies were taken into conservatorship.

In the case of Freddie and Fannie, the government engaged in time-inconsistent behavior. Prior to the crisis, it committed to supply only the $4 billion line of credit. During the crisis, the government instead chose to back all of the obligations of the two companies, which amounted to over $2 trillion in mortgage loan guarantees.

In fact, Freddie Mac and Fannie Mae provide a clear lesson about SIFIs and the time-inconsistency problem. They were perceived as "too big to fail," and this perception created a subsidy that allowed them to grow spectacularly while accumulating risks that were not adequately understood either by the markets or by their regulators. This contributed to distortions in the housing market (the large run-up in house prices from 2005–07), with adverse consequences for the financial system, the economy, and taxpayers.

REGULATORY PREVENTION

The example of Freddie Mac and Fannie Mae also illustrates the failure of one approach for dealing with SIFIs, which is the attempt to achieve regulatory prevention. Regulatory prevention means that regulatory agencies will, through rulemaking and supervision, prevent SIFIs from incurring risks that would require a bailout. In the case of Freddie Mac and Fannie Mae, regulators thought that the capital that those institutions were required to hold would be adequate to ensure their soundness. This proved to be incorrect.

The idea of regulatory prevention has historically proven to be a mirage. Agencies may be able to devise rules and procedures that would have prevented the last crisis, but the next crisis overwhelms these new measures.[1]

For example, after the Savings and Loan Crisis, regulators adopted risk-based capital regulations, because generic capital ratios could be gamed by financial institutions that held risky assets. However, it turned out that the risk classification system itself was gamed. This played a big role in creating the 2008 crisis.[2]

In general, quantitative rules such as capital ratios (risk-based or otherwise) are a weak tool for prevention. Over time, banks will innovate and seek regulatory adjustments that serve to undermine these rules. Such ratios cannot deal with other sources of risk, such as compensation practices that have the effect of rewarding individual risk-taking by traders or other individuals within the firm. In fact, quantitative measures can never cover all of the sources of risk within a financial firm.[3]

THE CASE AGAINST LARGE BANKS

Large banks are not the only potential source of risk for a systemic crisis. A financial system consisting solely of small banks could still be subject to a broad-based crisis if the risks that the banks take are highly correlated.

However, the time-inconsistency problem is essentially limited to large banks. For any individual small bank there is the possibility that, even in a crisis, the authorities will allow the bank to be restructured in a way that imposes losses on uninsured creditors. In the case of small banks, it is much easier for regulators to credibly commit to bail out only insured depositors.

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1. See Arnold Kling, "The Chess Game of Financial Regulation," *Lombard Street* 1, no. 2 (April 2009): 6–9, http://web.archive.org/web/20100710072059/http://www.finreg21.com/lombard-street/the-chess-game-financial-regulation.
2. See Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (Philadelphia: University of Pennsylvania Press, 2011); Thomas Hoenig, "Basel III Capital: A Well-Intended Illusion" (speech, International Association of Deposit Insurers 2013 Research Conference, Basel, Switzerland, April 9, 2013), http://www.fdic.gov/news/news/speeches/spapr0913.html; Arnold Kling, "Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, Sept. 2009), http://mercatus.org/publication/not-what-they-had-mind-history-policies-produced-financial-crisis-2008; and Thomas L. Hogan, Neil Meredith, and Xuhao Pan (2013), "The Failure of Risk-Based Capital Regulation" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, Jan. 2013), http://mercatus.org/publication/failure-risk-based-capital-regulation.
3. Amar Bhide, *A Call for Judgment: Sensible Finance for a Dynamic Economy* (New York: Oxford University Press, 2010).

One potential benefit of large banks would be that they have economies of scale and scope. However, the literature investigating this question has produced mixed results as to whether economies of scale even exist in the range of the largest banks. Perhaps the market is telling us that large banks are efficient, because the market has allowed them to emerge. However, we do not know to what extent large banks have emerged in the United States in response to genuine economies of scale and scope or to the benefits of the "too-big-to-fail" subsidy.

If there were genuine economies of scale and scope that operated at very high levels of assets, then it would be a mistake for public policy to seek to break up large banks. However, it seems reasonable to judge that the risks of losing significant economies of scale by breaking up large banks are small compared to the systemic risks that such banks pose.

In question 6, the agencies ask, "could the proposed strengthened leverage ratio requirement place U.S. banking organizations at a competitive disadvantage relative to foreign banking organizations and if so, in what areas?" This is a false issue.

The real issue is whether large US banks compete on the basis of genuine economies of scale and scope or because of the "too-big-to-fail" subsidy. Competing with foreign institutions on the basis of the "too-big-to-fail" subsidy is harmful both for the efficiency of the world financial system and for US taxpayers.

OTHER POLICY OPTIONS

The time-consistency problem distorts financial markets by creating a "too-big-to-fail" subsidy that favors SIFIs. Policymakers should consider the otherwise drastic step of intervening in markets to break up SIFIs as a way of eliminating this distortion. This section briefly mentions some alternative options of reducing the probability of future bailouts.

1. Not designating SIFIs. This might reduce the incentive of creditors to treat the debts of SIFIs as risk-free by creating some uncertainty about which institutions are SIFIs. However, by the same token, it might make it more difficult for regulators to craft and enforce SIFI-specific rules.

2. Creating classes of shareholders or creditors of SIFIs that are subject to financial penalties in the event of a bailout. In theory, these "added-liability" classes would influence management in the direction of avoiding a bailout. However, the question is whether these creditors would actively regulate management or merely act, like the writers of credit default swaps, as passive speculators on the institution's soundness.

In any event, regulators should not be satisfied that the proposed increases in capital ratios are adequate to achieve regulatory prevention.[4] Instead, regulators should make it clear to members of Congress that it may not be possible to protect taxpayers from bailing out SIFIs and that the time-consistency problem distorts markets by subsidizing SIFIs.

It may be that the approach that minimizes government distortion of markets is to break up these institutions. Taking such a step may be outside the scope of existing legislation. That being the case, what agencies can do is point out to Congress how, under existing legislation, SIFIs create financial fragility and potential for bailouts beyond what can be mitigated through regulation.

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4. Anat Admati and Martin Hellwig have argued that capital requirements as high as 25 or 30 percent are needed. See Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* (Princeton: Princeton University Press, 2013).