UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 18 | Issue 1 Article 10

2013

Financial Regulation Reform: Politics, Implementation and Alternatives

Anat R. Admati

Follow this and additional works at: http://scholarship.law.unc.edu/ncbi

Part of the Banking and Finance Law Commons

Recommended Citation

Anat R. Admati, *Financial Regulation Reform: Politics, Implementation and Alternatives*, 18 N.C. Banking Inst. 71 (2013).
Available at: http://scholarship.law.unc.edu/ncbi/vol18/iss1/10

This Comments is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

FINANCIAL REGULATION REFORM: POLITICS, IMPLEMENTATION AND ALTERNATIVES

BY ANAT R. ADMATI*

Anat Admati argues that the banking system is too fragile and inefficient, and that reform efforts have been flawed. The fragility of the system causes booms and busts, and busts lead to bailouts when authorities fear the alternatives are worse. A key problem is that banks and other institutions rely excessively on borrowing, which combines with opacity and a high level of interconnectedness to create an unnecessarily fragile, dangerous, and inefficient system. The level of indebtedness in banking has nothing to recommend it; rather it reflects the private and distorted incentives of bankers and bank shareholders, and the failure of credit markets to contain risk in banking. To protect the public from excessive risks and harm in banking, we need effective capital regulation, but a combination of confusion and political forces has prevented beneficial reform in this area. Anat Admati addresses these issues and suggests useful steps going forward.

I. INTRODUCTION

I start with a grim assessment: much is wrong with banking.[1] The banking system is too fragile and very dangerous. It exposes the public to unnecessary risks and creates large distortions. Banking also suffers from huge governance problems. Markets fail to produce an efficient outcome in banking, and as a result it allows bankers to benefit at the expense of others and harm and distort the economy. Regulation is essential, but it is ineffective in most countries, to a large extent because of the politics of banking. As a result, the banking system does not support the economy as well as it could.

---

* George G.C. Parker Professor of Finance and Economics, Graduate School of Business, Stanford University.

1. For an in-depth analysis of the current state of the financial system, see the author's new book, ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

Why is banking fragile? One key is high leverage or indebtedness. Worse, bank borrowing tends to rely on deposits and very short-term debt, which is particularly fragile. Worse yet, the system has a high degree of interconnectedness, resembling a set of dominoes standing one next to another and this gives rise to contagion effects.

Contagion takes a few forms. First, contractual connections involving chains of borrowing and lending within the system imply that the distress or failure of one bank immediately weakens its counterparties. In addition, investors infer information from the distress of one institution to assess the strength of others. And if institutions must sell assets after losses, there are dynamics in asset markets that lower prices and exacerbate the weaknesses.[2]

Finally, there is great deal of opacity in the system, which means we do not even know what is going on. Many commitments are off-balance sheet and unreported. Institutions in the so-called "shadow banking system" that is less regulated or unregulated are often connected and supported by regulated institutions, but the resulting risks are often misunderstood or not sufficiently considered.[3] Derivatives traded in over-the-counter markets can create significant exposures. Many such exposures are "netted" in financial statements, but this hides potential fragilities prior to default. Such dynamics played out in the final days of Bear Stearns and Lehman Brothers.

Accounting conventions can mask losses and other information that investors and regulators should know about but often do not. In the Lehman Brothers' case, thousands of subsidiaries that had previously been undisclosed emerged in the bankruptcy process. The legal process associated with the failure of a large global bank is very messy indeed.

The distortions of this system are enormous. One of them is evident from the existence of so-called "too-big-to-fail" megabanks

---

2. *See, e.g.*, Letter from William C. Dudley, President, Fed. Reserve Bank of N.Y., 2012 Ann. Rep. 8 (2013) *available at* http://www.newyorkfed.org/aboutthefed/annual/annual12/pres_letter.pdf ("Going forward, we need to look at the larger issue of the appropriate role of wholesale funding in the financial system. We need to evaluate how comfortable we should be with a system in which critical financial activities continue to be financed with short-term wholesale funding beyond the scope of the type of lender-of-last resort facility that reduces the risk of runs and asset fire sales that can threaten the stability of the entire financial system.").

3. *See generally* FIN. STABILITY BD., STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING § 1.1 (2012), *available at* http://www.financialstabilityboard.org/publications/r_121118.pdf.

(with many colorful variations on this theme, including "too big to jail," too systemic, etc). For these institutions, investors expect that, at least in certain situations, the debts will be guaranteed or paid by taxpayers, i.e., the institution will not "fail" to pay its debt. Being "systemic" is not unique to traditional banks. For example, AIG, an insurance company, was bailed out (and the banks that were owed collateral calls were paid in full). The hedge fund Long Term Capital Management (LTCM) was also considered "systemic" and it did not fail in the normal way back in 1998.[4]

Other types of distortions arise in banks' lending and investment decisions. Banks love to threaten that they will stop lending if regulations are tightened. In fact, they have money that can be used to make loans, but they choose to do other things. That is partly because banks are highly indebted and are impacted by a debt overhang effect that biases their decisions, and partly because of the structure of the regulation. Capital regulation gives banks incentives to invest in assets that are considered relatively safe by the regulation and thus have relatively low (or even zero) risk weight, but which in fact have a bit more risk and promises returns accordingly.

The result is a system with many booms and busts, where banks often lend too much or too little. Lending decisions are inefficient as a result of excessive borrowing and the resulting conflict of interest between borrowers and creditors that it creates. There are two effects: first, highly indebted borrowers want to make excessively risky investments because this enables them to benefit at the expense of creditors. Second, highly indebted borrowers may avoid making certain worthy investments because the investments benefit the creditors at their expense. There is not enough "upside" for them.

There are governance problems all over the place in banking. Who makes decisions? Who is affected? It starts with the bankers. They make decisions and they benefit the most from the situation. Shareholders might get a piece of the upside, but they are harmed if managers take risk that shareholders may not even be aware of or for which they are not properly compensated. Shareholders also pick up the tab for misconduct. Creditors, unless they are insured, may end up

4. *See* PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 10-22 (1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf.

possibly bearing downside risk without receiving the upside. Taxpayers are harmed if the government decides to bail out banks using taxpayer money, and the public at large is harmed from inefficient lending and the collateral damage of a crisis.

The public needs protection in this situation. Regulators and politicians are charged with doing it, because the market fails to contain the excessive risk. Society suffers from all the distortions of this incredibly inefficient system.

II. WHAT MIGHT WE DO TO IMPROVE BANKING?

Better resolution is one possibility, so we can allow ourselves to "let banks fail."[5] However, even in the best case, resolution is extremely disruptive, and, at this point, the cross-border issues are unresolved and seem unresolvable. Moreover by the time resolution is triggered (if ever), it is too late, because the great inefficiencies start with distress. Debt overhang is a source of inefficiency, and it arises with any non-equity funding, because the decision makers, who have the ultimate remainder of the profit, make different decisions than they would have made if they were making investments with their own money, fully considering the upside and the downside.[6]

Another direction for addressing the problems in banking is various proposals for structural reform. The challenge and the difficulty is the interconnectedness in the system. Being "systemic" and causing collateral damage of failure is not about depositors—some of the systemic institutions were not deposit-taking institutions. Moreover, we can have many small institutions that fail at the same time as happened in the Savings and Loan crisis. The biggest banks are obviously the most dangerous and the ones who obviously have the most distorted incentives in the system. But too many small, inefficient, and connected banks can also create a problem. Not every business in the economy has a right to come to Washington and insist on staying around because it is

5. *See*, Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, §§ 201-17, 124 Stat. 1376, 1442-1520 (2010) (codified at 12 U.S.C. §§ 5381-94 (2012)); Orderly Liquidation Authority, 12 C.F.R. § 380 (2012).

6. Once a firm is highly leveraged, any reduction in debt or increase in equity to reduce that leverage is an uncompensated benefit to debt holders because it lowers the risk of default on that debt. *See* Anat R. Admati et al., *The Leverage Rachet Effect* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 146, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304969.

a Mom and Pop business.

Here are two analogies to keep in mind. Borrowing tends to be addictive. So think of banks as sick, addictive institutions. If you have just resolution, this is akin to emergency vehicles and coroners lined up for the emergency situation if they overdose. The safety net that banks benefit from actually feeds the addiction and enables it, paradoxically. Can we fight back and control the addictions?[7]

For analogy number two, think of trucks driving fast through a residential neighborhood carrying explosives. Can we slow them down with speed limits? The system we have instead subsidizes the trucks when they drive faster.

III. WE ARE NOT STUCK WITH THIS FRAGILE AND INEFFICIENT SYSTEM!

We are not stuck with this system, but we somehow got confused into thinking that we are. There is an obvious place to start to make the system safer and more resilient, as well as healthier and less distorted. Financial institutions do not need to be so fragile. The reason they are fragile is that they want to be and that they get away with it. We can force them into the same funding considerations of most other companies by requiring them to rely much more on equity funding. The safety net has expanded way too much, and the entitlement to that safety net has only gotten worse since the crisis. We can reduce this fragility; we just have to want to do it.

If we reduce the leverage (indebtedness) and jack up equity requirements, many good things will follow. If the transition is handled properly, I cannot think of one bad thing, not even one. Everything else that is said on this subject is false. Equity represents funding with unborrowed money and more equity means that losses can be absorbed without leading to distress or insolvency.[8]

Historically, banks were not so highly leveraged. In the nineteenth century there were unlimited liability partnerships with fifty percent equity. Banks were often the last entities to become limited

---

7 *See* Anat R. Admati et al., *supra* note 6.

8 For a full analysis of the benefits and purported costs of increased equity requirements, see Anat R. Admati et al., *Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulations: Why Bank Equity is Not Socially Expensive* (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper No. 86, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669704.

liability. Some remained partnerships and some even remained with unlimited liability for shareholders. Adding equity now has the effect of effectively increasing the liability of the banks.

No industry has as high leverage as banks, even though we do not regulate how most companies fund. If you dare to say banks should have thirty percent equity, when banks' equity is in the single digits, they think you are crazy, but these are in fact minimal levels in the rest of the economy, and most companies could not borrow much more under terms that are attractive enough. We know that high leverage creates significant inefficiencies. What is the problem with having more equity in banking?

Corporations in the rest of the economy need to be able to attract enough equity investors, and often retain their earnings and avoid relying on too much borrowing. No healthy corporation lives on the edge like banks. Indeed, no viable corporation needs to live on the edge like that, including banks. The banks start with the overhang from deposits, and from that point on, they have the "ratchet" effect of being biased towards more borrowing and resisting equity because borrowing and risk allow them to take advantage of their creditors (depositors and others). When you add deposit insurance, bankers want to have as little equity as possible so as to take advantage of the insurance. The result is an inefficient industry. The choices bankers make do not give us the right benchmarks. The single digit equity levels are just what we got used to, what the banks have been able to get away with. There is nothing else to recommend them.

How much equity should banks have? Basel II required two percent of risk-weighted assets for "Tier 1 capital" (which is not entirely common equity and some of it resembles long-term debt). Basel III puts the figure at seven percent, which can be drawn down to 4.5 percent of risk weighted assets.[9] They tell you this tripled the previous requirements, and they want to imply that the new requirements are really tough. Relative to the total assets, Basel III allows equity to be as low as three percent.

Many of us believe Basel III is outrageously insufficient. Martin

9. *See* Press Release, Bank for Int'l Settlements, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards (Sept. 12, 2010), http://www.bis.org/press/p100912.pdf; *see also* Reserve Requirements of Depository Institutions (Regulation D), 12 C.F.R. § 204 (2013).

Wolf, in a column entitled *Basel III: The Mouse That Did Not Roar* said, "This [tripling the previous requirement] sounds tough, but only if one fails to realise [sic] that tripling almost nothing does not give one very much."[10] For the last four years, I have been asking, first just in the hallways and seminar rooms and then more publicly: What's wrong with, say, twenty-five percent equity? I have gotten no valid answer.[11]

They say "lending will suffer" with higher equity requirements, but this makes no sense. In fact, lending suffered when banks became distressed because they borrowed a lot and lost on their previous investments. Loans can be made with shareholders' money, not only with borrowed money. Companies in the economy invest and grow while borrowing little, especially in the high tech, near my university, Stanford. Investments are funded by venture capital and owner equity. There is plenty of equity funding for valuable investments, and banks can have some of it if they offer sufficient value.

How to get there? Start by banning payouts to shareholders from earnings. Then require that new equity be issued. If a bank cannot raise equity at any price, it may be too weak, maybe insolvent, and we want to know this and eliminate such "zombie banks" as soon as possible, unwinding them quickly because they do not help the economy.

How much equity? Let's shoot for about thirty percent of total assets. This does not interfere with taking deposits or providing "liquidity." Equity is meant to make the debt safer. If risks are taken, someone must bears the losses should they occur, and it should definitely not be taxpayers.

The more banks fund with debt and correspondingly little equity, the situation resembles them polluting the financial system and the rest of the economy. The more debt relative to equity, the more systemic risk is generated. As it stands, we subsidize debt and penalize equity funding. Banks respond by using a lot of debt and very little equity, thus generating a lot of systemic risk. The tax subsidies of debt

10. Martin Wolf, *Basel: The Mouse That Did Not Roar*, FIN. TIMES, Sept. 14, 2010, http://www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html.

11. *See, e.g.*, Jesse Eisinger, *In Brown-Vitter Bill, a Banking Overhaul with Possible Teeth*, N.Y. TIMES DEALBOOK (May 1, 2013, 12:00 PM), http://dealbook.nytimes.com/2013/05/01/in-brown-vitter-bill-a-banking-overhaul-with-possible-teeth/ (highlighting legislative efforts, thus far fruitless, to raise minimum equity level to 15%).

are entirely perverse. The guarantees are either explicit through deposit insurance, or implicit and difficult to credibly take away by saying: "there will not be bailouts," when bailing out might be better than alternatives.

The bottom line is that, perversely, banks receive subsidized funding when they borrow but not when they fund with equity. Thus we effectively subsidize banks by encouraging them to "pollute" with their mix of funding. Do banks pass their subsidies to the economy? If we want to encourage lending, this is a strange way to do it, because the subsidies are not attached to any specific activities, and lending is only a small part of what banks do. There is actually little to suggest that banks reduce spreads when they are more highly indebted. And in any case, the cost of credit should be determined in the same undistorted way that other investments in the economy are made.

From bankers' perspective, equity is "expensive" in the sense that they prefer to borrow as a result of multiple forces. First, the debt overhang effect that creates addiction to leverage and resistance to any leverage reduction is very strong given that banks are already highly indebted. Changing the funding mix shifts downside risk to shareholders that they can otherwise get others to bear. Tax subsidies are available to all corporations, yet we do not see as much borrowing by other corporations. For banks, it's one more reason to prefer debt funding. In addition, as discussed, guarantees, and particularly implicit guarantees that banks don't pay for provide strong incentives to borrow. Finally, bankers are fixated on return on equity (ROE) measures as if they reflect value creation. More borrowing tends to increase the risk of the equity and thus increase the average ROE (although actual ROE is lower if losses are incurred). However, as indebtedness increases, so does the required return on equity, and whether the ROE produced by banks compensates investors for the risk they bear is not clear.[12]

For society, none of these reasons represents a relevant cost to having banks fund with more equity. Another dollar funded in equity is much better than another dollar funded in debt. Much of banks' debts serve no useful purpose, and in any case, adding equity is possible.

Basel III also allows too long for implementation, till 2019. Martin Wolf said in the same column "by 2019 . . . the world will

12 ADMATI & HELLWIG, *supra* note 1 explains these issues in detail in Chapters 7-8.

probably have seen another financial crisis or two."[13] In Europe at least, we seem to be in a crisis still (or again).[14] And policymakers continue to deny and avoid tackling problems in banking that result from the weakness of many banks. This approach is misguided and allows the system to be a drag on the economy. It is best to face the weakness of some of the banks and strengthen the viable ones as soon as possible.

The risk-weighted capital requirements are another major flaw in the Basel approach. It was shown to be counterproductive and has in fact allowed banks to increase their indebtedness and to concentrate their risks, increasing interconnectedness. Banks have incentives to find investments with low risk weight, i.e., which regulators view as relatively less risky, but which in fact have more risk and thus more return. Banks within the Eurozone lend to governments within the zone using just borrowed money, because all government debt is considered riskless (receiving zero weight) as if it cannot fail. In the U.S., lending to municipalities receives a very low risk-weight. AAA-rated securities, which banks loved to invest in before the crisis, turned out risky and took down some banks.

In addition, Basel II and Basel III allow banks to use their own models, and this gives banks ways to try to manipulate the regulation. The regulation also allows non-equity securities to be counted on to absorb losses, even though such securities did not actually absorb losses in many institutions that were bailed out. These approaches are flawed or unnecessary. They are dominated by requiring banks to rely on much more common equity as a way to correct many distortions in the system.

Central banks are on a slippery slope when their so-called "liquidity supports" turn into disguised bailouts, lending at below market rates and against questionable collateral. Financial stability gets mixed up with other objectives, sometimes political, that affect policy, regulation, and enforcement.

IV. WHY ARE WE HERE? BANKING MYTHS AND POLITICS

In most countries, and certainly in the U.S., particularly after the

---

13. Martin Wolf, *supra* note 10.

14. *See, e.g.*, Emma Thomasson & Alexander Smith, *Bankers, Policymakers Say Europe's Crisis Not Over*, REUTERS, Jan. 26, 2013, *available at* http://www.reuters.com/article/2013/01/26/davos-eurozone-crisis-idINDEE90P03Q20130126.

Dodd-Frank Act, regulators have sufficient authority to keep the system safe. Yet they are failing. For example, for the third year, the Federal Reserve has allowed most large U.S. banks to pay dividends to shareholders. The policy chooses the banks' interests over those of the public.

There is no justification for allowing these payouts by the banks. The payouts benefit primarily the bankers themselves, or those whose holdings are concentrated in the banks. Diversified shareholders and the public are exposed to unnecessary risk and the system is made more fragile. The stress tests are very flawed and unconvincing.

Why are policymakers failing? If you listen to them, they will have their narratives and their "analyses." A favorable narrative holds that everything in banking is "just a liquidity problem." Think of it as the "plumbing narrative." The narrative is convenient, because it starts with runs and breakdowns that appear as if they are a natural disaster, thus avoiding the question of why regulators and supervisors allowed these risks to build up.

The banks lobby using very flawed claims, and they are successful because they are rarely challenged either because those involved do not know how to challenge the claims (they might in fact agree with them), or because they do not want to challenge the claims. The public gets scared by the threats made by the lobbyists about all the terrible things that would happen if regulators try to make banks safer.

One problem appears to be ignorance on the part of too many people involved, and certainly on the part of the public. Most people do not even know what the word "capital" is in banking. They think it is a rainy day fund, a cash reserve sitting idle. With this interpretation we are not even at the starting point of the debate on the costs and benefits of banks' indebtedness. Then, of course, there are major misunderstandings of the economics of funding. It seems hard and technical, certainly by the time you get to risk-weights and other details. I no longer know why people say what they say.

I do not blame people for not knowing, though I am shocked to be told that bankers do not understand some of the basic principles that apply to their own business. The other problem has been, however, that people do not want to engage. The problem goes from what they know to what they *want to know*, or what they *want to acknowledge* if they do know.

Martin Hellwig and I tried to engage with regulators and policymakers and found that many of them do not want to hear what we have to say. The lack of engagement includes academics as well. Challenging people and the prevailing narratives is not fun, but the invalid claims, combined with the politics that Martin will elaborate on, are harmful. So we decided to explain the issues so that a broader audience can participate and anyone involved who has any "blind spots" has an opportunity to consider the issues.

Our book, *The Bankers New Clothes: What's Wrong with Banking and What to Do About It*,[15] explains things very slowly and patiently, using a home mortgage example to make many of the key points. We hope that the book will elevate the debate and expose the nonsense and the politics. Otherwise, we fear, and quite possibly despite our best efforts, we will have to live with this unhealthy and dangerous system, at least until another major crisis.

15. ADMATI & HELLWIG, *supra* note 1.