The Role of Capital Standards in Assuring a Healthy Financial System

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Introduction

The Dodd-Frank Act has given banking supervisors and other regulators a wide range of tools to help ensure that the US financial markets are healthy and stable. Among its many provisions, the Act reinforced bank supervisors' responsibility to assure that bank holding companies are well capitalized and able to withstand shocks. Supervisors have substantially improved bank capital requirements, although higher capital requirements would probably be beneficial. Amendments that would reduce capital and other risk management requirements or limit the information banks make available to supervisors are dangerous, and threaten to expose taxpayers to more risk.

The Role of Capital

Every business owner knows it takes a bit of capital to get the business started. You want to set up shop? You need to have something to put into the business. You may be able to borrow a portion of the capital needed, but potential creditors will want to know you have some skin-in-the-game, too.

In the decades leading up to the financial crisis of 2007-2009, many banks tried to avoid this simple proposition and operate without much of their own capital at risk. The only reason a bank is able to keep functioning without its own capital at risk, is the taxpayer backstop. Banks perform essential services, and when a crisis erupts, taxpayers' are faced with a hostage situation: if the bank goes down,

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then the services stop, too. Taxpayers are then forced to pay up in order to keep the system operating. The availability of this taxpayer backstop is what makes it possible for a bank to function without much equity capital.

These are the issues at stake in today's discussion of capital requirements. How much of their own money should banks be required to have invested in their business? When times turn tough and the bank runs into a string of losses, will it be the banker's own capital that takes the hit, or, will the taxpayers be the ones who take the hit?

A group of prominent financial economists propose that the figure be at least 15%.[2] Even with the recently announced capital surcharges for the largest US banks, the capital required is well below that prudent level.[3]

The Many Different Ratios

Discussions about bank capital requirements get very confusing very fast. What starts out as a simple ratio of two numbers—equity in the numerator and assets in the denominator—quickly turns into a discussion of many alternative ratios distinguished by the many different ways one can define equity and assets. Sometimes the push to use an alternative ratio is inspired by banker self-interest: if they can convince us that some of their assets "don't count", then they can get by with less capital.[4] But some of the variety in ratios reflects the complex nature of the banking system and the many different activities that share the label "banking". Each of us is familiar with the banks' role taking deposits and, perhaps their role in making loans. Even in these familiar businesses there are different types of deposits and types of loans in which different banks specialize. Mortgage servicing is another line of business that may be familiar to many. Less familiar to the average person are the lines of business that involve global payments, custodial services, and market making services. These diverse lines of business

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[2] "Healthy banking system is the goal, not profitable banks," Financial Times, November 9, 2010. The 15% figure measures equity to banks' total, non-risk-weighted assets.

[3] Federal Reserve, Press Release, July 20, 2015, http://www.federalreserve.gov/newsevents/press/bcreg/20150720a.htm. http://www.usatoday.com/story/money/2015/07/20/fed-capital-surcharges/30413471/.

[4] An outstanding guide to understanding bank capital and capital requirements is the book by Professors Anat Admati and Martin Hellwig, The Bankers' New Clothes, Princeton University Press, 2013.

require different investments and are exposed to different risks. The amount of capital needed to assure that the equity owners cover the business' risk may be different.

I will use as an example a line of business that I pay particular attention to, dealing in derivatives.[5] Although these dealerships are major lines of business, they hardly register on the banks' balance sheet. For example, JP Morgan's 2014 balance sheet shows total assets of more than $2.5 trillion. That number includes less than $80 billion in derivatives, although JP Morgan actually holds more than $1.3 trillion in derivative assets.[6] That is because US accounting rules permit the bank to net out a large fraction of its derivative liabilities from its derivative assets when presenting its balance sheet. However, banks reporting under international accounting standards must report a much larger amount of its derivative assets on its balance sheet: they cannot net out as large a fraction of their derivative assets.

Which version of total assets should be used in calculating a bank's capital ratio, the net assets or the gross assets or something else?

The major dealers argue in favor of the US GAAP definition where a significant portion of the assets have been netted down.[7] They focus on the fact that in bankruptcy a large amount of the derivative liabilities will be netted against the derivative assets.

This is clearly wrong. The focus on what happens in bankruptcy is a terrible example of whistling past the graveyard. The problem is that this netting only takes place if we arrive at bankruptcy with those same exposures in place. A lot can happen before a bank fails which changes the picture dramatically. More importantly, what we first need to be concerned about are the forces that drive a bank towards failure. We should want to avoid failure in the first place. In that regard, net derivative asset understates the risk.

[5] The CFTC's list of designated dealers is here:
http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer

[6] JPMorgan Chase & Co. Annual Report 2014. The balance sheet is on page 174. The detail on the derivative holdings, is in Note 6 to the Financial Statements, on page 186 under "Total Derivative Receivables". The gross figure is calculated by summing the Level 1, 2 and 3 values.

[7] ISDA, "Netting and Offsetting: Reporting derivatives under U.S. GAAP and under IFRS," May 2012.
https://www2.isda.org/attachment/NDQxOQ==/Offsetting%20under%20US%20GAAP%20and%20IFRS%20-%20May%202012.pdf

For a bank that deals in derivatives, a large fraction of the derivatives should be thought of as short-term positions in the same fashion as demand deposits. Counterparties expect their dealers to stand ready to liquidate or novate positions, just as people expect to be able to withdraw the balances in their checking and savings accounts–on demand. Were a dealer bank to hold up liquidations, it would only add fuel to the fire of suspicion that the dealer bank is insolvent. Consequently, a small net exposure at a dealer bank can suddenly balloon to a large net exposure over the next few days as counterparties liquidate or novate the positions on which the bank owes them money. A regulator that paid attention only to the banks net exposure would not have appreciated the dangers of such a run. Moreover, should the bank ultimately arrive in bankruptcy where the derivative assets and liabilities are netted against one another, the scale of actual netting will now be much smaller than originally anticipated due to the intervening bank run. The original net exposure was deceptive in measuring the ultimate losses to those parties left holding the bag.

We need only look back at two major bank runs of 2008 to see the point—Bear Stearns and Lehman Brothers. The Report of the Financial Crisis Inquiry Commission is especially detailed on how derivative counterparties participated in the run on Bear.[8] Good popular accounts are available in a Vanity Fair piece by Bryan Burroughs and in William Cohen's book House of Cards.[9] A more technical discussion is provided by Professor Darrel Duffie in an article on the "Failure Mechanics of Dealer Banks".[10]

The example of a derivative dealer's risk explains why banking supervisors do not take the balance sheet at face value. The Federal Reserve, for example, obtains reports that include the derivative dealer's full gross portfolio positions, and also requires the bank to calculate measures of potential exposure that reveal some of the potential risks embedded in the business of dealing derivatives along with other sources of systemic risk. The risk of a run on a dealer and other liquidity risks also motivate complementary controls such as the Liquidity Coverage Ratio.

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[8] Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011, see esp. pp. 287-288 & 291. See also their conclusion on Lehman, p. 343. http://fcic.law.stanford.edu/report.

[9] Bryan Burrough "Bringing Down Bear Stearns," Vanity Fair, August 2008. http://www.vanityfair.com/news/2008/08/bear_stearns200808. William Cohan, House of Cards: A Tale of Hubris and Wretched Excess on Wall Street, Doubleday, 2009.

[10] Duffie, Darrell. 2010. "The Failure Mechanics of Dealer Banks." Journal of Economic Perspectives, 24(1): 51-72. https://www.aeaweb.org/articles.php?doi=10.1257/jep.24.1.51.

This brings me to some of the current proposals for amending Dodd-Frank and bank capital regulations.

Reform of the Reform?

The Dodd-Frank Act reinforces bank supervisors' responsibility to assure that banks hold adequate capital. It mandates higher scrutiny as banks grow larger and more complex. The provisions in Section 165 have become a focal point of late, with some proposals made to raise the $50 billion threshold. There have also been proposals to encumber the supervisory process by requiring designation by the Financial Stability Oversight Council before the higher scrutiny could be applied.

Proponents suggest that the current law labels all bank holding companies with assets above $50 billion figure systemic, and that they are all held to a uniform higher standard that is inappropriate to those closer to the $50 billion size. This is not true. The $50 billion figure is a threshold for increased scrutiny and gives supervisors the authority to apply differentiated measures as the facts demand it. Federal Reserve Governor Daniel Tarullo and FDIC Chairman Martin Gruenberg testified about this process in Senate hearings this past March.[11] In testimony earlier this month to your Subcommittee on Financial Institutions and Credit, my colleague Professor Simon Johnson provided detail on how the Federal Reserve's Systemic Risk Report enabled the Fed to differentiate among these bank holding companies and determine which ones merited additional measures, and he provided useful detail on specific bank holding companies.[12]

Supervisors can't know about risks if they don't look. Raising the threshold only invites blindness to risks, inadequate capital requirements, and the return of a taxpayer backstop to banks. The letter

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[11] Governor Daniel K. Tarullo, Application of Enhanced Prudential Standards to Bank Holding Companies Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. March 19, 2015, http://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.htm.
Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation: Examining the Regulatory Regime for Regional Banks before the Committee on Banking, Housing, and Urban Affairs; 538 Dirksen Senate Office Building; Washington, DC, March 19, 2015, https://www.fdic.gov/news/news/speeches/spmarch1915.html.

[12] Simon Johnson, "Examining the Designation and Regulation of Bank Holding Company SIFIs," Prepared remarks submitted to the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee for the hearing "Examining the Designation and Regulation of Bank Holding Company SIFIs", July 8, 2015, http://www.iie.com/publications/testimony/johnson20150708.pdf.

from Americans for Financial Reform in opposition to HR 1309 helps explain these dangers in that proposal, as does the Fact Sheet from the organization BetterMarkets.[13]

[13] http://ourfinancialsecurity.org/2015/03/afr-presentation-to-senate-banking-staff-on-regulation-of-large-regional-banks/, and http://bettermarkets.com/blog/updated-fact-sheet-everything-you-need-know-about-50-billion-threshold.