

Are We on the Right Path?

Four years ago, I served as interim director for Bank Supervision and Regulation at the Board of Governors.

When I arrived in Washington during the summer of 2009, the fatigue was evident. Many people were frustrated trying to answer the question of how a premier regulator such as the Federal Reserve failed to prevent or at least cushion the financial crisis with its supervisory tools.

Today, we find ourselves wading through the significant, additional responsibilities Congress handed the Federal Reserve, thousands of pages of legislation and rules to implement, and dramatic changes in our supervisory regime. Federal Reserve economists now participate prominently in bank supervision to design and validate models, to create economic scenarios for stress tests and contribute independent judgments on analytical assumptions and data. And yet a nagging question continues to surface in the media, the Congress and even among policymakers: Are we on the right path?

I believe policymakers must answer this question confidently and should not declare victory even as progress is being made. There are still a few areas that I believe must be addressed to ensure the fixes are not just incrementally better, but sufficiently substantive to be durable and effective.

From financial crisis fatigue to today

Since 2009, we've covered a lot of ground in strengthening supervision. Congress has passed massive reform legislation focused importantly on enhanced prudential standards and financial stability. The United States has a

Financial Stability Oversight Council and Office of Financial Research. For the Federal Reserve, large bank supervision improvements have been the focal point.

Comprehensive Capital Analysis and Review (CCAR) and stress tests have become core components of our supervisory regime. And recently, the banking agencies have approved the new and reportedly improved Basel III framework and proposed a higher supplemental leverage ratio for the global systemically important banks. Clearly, we've done a lot; we've stepped up our game.

Lessons from history

As I observe the efforts to shore up the financial system and its regulatory apparatus, I am reminded that history has much to offer us about the prospects for a successful regulatory response to the crisis.

Look back to the Great Depression era. The Pecora Commission and its findings resulted in the Glass-Steagall Act's separation of commercial and investment banking and the establishment of deposit insurance. Despite these significant changes, some were left uneasy that the rules could prevent future problems.

For example, a book called "Wall Street Under Oath" noted the following concern: "Under the surface of government regulation, he (Pecora) wrote, the same forces that



produced the riotous speculative excesses of the ‘wild bull market’ of 1929 still give evidence of their existence and influence...It cannot be doubted that given a suitable opportunity they would spring back into pernicious activity.”

In the 1970s, these safeguards began to erode as a result of market innovation and regulatory easing. By the summer of 1982, the failure of a community bank in my district, Penn Square Bank in Oklahoma City, set off a chain of tremors that ultimately led to a government rescue of Continental Illinois—the largest bank failure in U.S. history until the collapse of Washington Mutual in 2011, the bailout of the nine largest financial institutions in 2009 notwithstanding.

Will the steps taken to date be enough to secure a more stable financial system for the future? Professor Ed Kane would argue it’s doubtful in his characterization of the cat-and-mouse game called “regulatory dialectic.” That is, the pattern that looks like this: Binding regulations lead to sub-optimal outcomes for banks, their customers or their nonbank competitors. In response, these agents will engage in avoidance behaviors and look for loopholes in the regulations to gain the unexploited regulatory rents. The result is a series of repeating cycles of regulation, regulatory avoidance and re-regulation. In recent years, an even faster pace of change has been driven by improvements in information technology.

In general, the regulation/avoidance/re-regulation cycle is asymmetric in the sense that the regulation/avoidance phase tends to be shorter than the avoidance/re-regulation

phase. Bankers and markets tend to adapt quickly, especially when large rents are the prize. Bankers and their competitors tend to be very efficient at adapting. In addition, the regulatory lag tends to be exacerbated by the inherent opaqueness of financial firms.

So how should we evaluate our success to date? Professor Kane might suggest that it is only a matter of time before the work of financial reform since 2010 will give way to stronger incentives to game the system. That is undoubtedly true. But we will have a better chance of shortening the regulatory response time—and thereby limiting the damage to society when the next crisis comes, as it surely will—by taking additional steps to strengthen our supervisory and regulatory framework in three areas: a strong leverage ratio, a commitment to the value of experienced and well-trained examiners, and structural alterations to the financial system that limit the safety net.

Quantitative measures are not enough

From Basel I to I.5, to II, II.5, and now to III, as the largest banking companies got larger and more complex, a greater emphasis has been placed on capital and risk-modeling at the expense of supervision and market discipline. Today, with the banking agencies’ approval of Basel III, regulators have noted the importance of higher levels and quality of capital, although the approach to capital requirements is largely the same, with the largest firms using internal

models and all others using risk weights established by regulators.

As the Bank of England's Andy Haldane highlighted in a paper presented a couple of months ago at a conference sponsored by the Federal Reserve Bank of Atlanta, the evolution of Basel capital requirements went from "a regulatory regime of constrained discretion ... to one with too much unconstrained indiscretion."¹ He and others have noted the steady downward trend in risk weights and upward trend in leverage leading into the crisis. He also shows that variability in estimated probabilities of default and risk weights across banks for a given hypothetical portfolio is too large to be explained by reasonable diversity in risk models, which raises further questions about the reliability of internal models for determining regulatory capital ratios. The Basel Committee found similar results in a study of the trading book released in January and a study of the banking book released recently.² Other studies have found that as the result of manipulating risk weights, the average risk weights declined for 115 banks from Organisation for Economic Co-operation and Development countries after their Basel II internal models were approved.³

The 2012 10-K forms for the six largest bank holding companies totaled 1,900 pages, much of which is in small footnote print. I've looked at these reports and find little informational value can be gleaned. For those

looking to assess capital adequacy, one survey found that more than 85 percent of 130 investors did not view risk weights as very trustworthy, while more than 60 percent said their confidence in risk weights has declined.⁴ I've talked to several fixed income and equity analysts who say they don't pay any attention to risk-based capital ratios and focus instead on leverage ratios.

This suggests to me that reforming capital regulation will require a different approach if we want different outcomes. In particular, a number of studies find that simple leverage ratios do as well as or better than risk-based ratios in predicting bank failures. So I was glad to see the notice of proposed rulemaking on the higher supplemental leverage ratio for the global systemically important banks. More broadly though, policymakers should push ahead with making a strong leverage ratio a foundational and binding requirement for all financial institutions.

Secondly, just as we have committed to a multi-disciplinary approach to supervision, we should recommit to the value of a strong bank examination process. The focus on internal models and their increasing complexity has redirected much of our attention and resources to assessing models over the past few years with CCAR, stress tests, capital planning and risk management.

While more data and more specialists offer us new insights, it will not deliver better

¹ Andrew Haldane, "Constraining Discretion in Bank Regulation," Federal Reserve Bank of Atlanta Conference on "Maintaining Financial Stability: Holding a Tiger by the Tail(s)," April 9, 2013.

² Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP), "Analysis of Risk Weighted Assets for Market Risk," BCBS 240, January 2013 (rev February 2013), and "Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book," BCBS 256, July 2013.

³ Mike Mariathan and Quarda Merrouche, "The Manipulation of Basel Risk Weights," CEPR Discussion Paper No. 9494, May 2013.

⁴ "Bye Bye Basel? Making Basel More Relevant," Barclays Equity Research, May 23, 2012.

supervision of large firms in the long run unless we emphasize the importance of well-trained, experienced examiners.

What makes a good supervisor? There is of course no Ph.D. in bank supervision. You build it with training, experience and judgment. You encourage healthy skepticism and getting answers to unpopular questions. You learn from experience how to cut through complexity and get to the core issues.

The Federal Reserve's credibility as a supervisor was built on the reputation of past leaders like Bill Taylor who embodied the ideals of a central banker and a bank supervisor as described by Bill McDonough, former New York Fed president: "measured, professional, impartial, and unstinting in his willingness to go the extra distance in his search for the right answers to the problems he needed to address." Although not particularly flattering, Bill Taylor described an examiner this way: "A bank examiner is someone who always looks past middle age, is wrinkled, cold, passive, noncommittal, with eyes like a codfish. Polite in contact, but at the same time unresponsive, cold, calm, damnably composed as a concrete post or a plaster of Paris cast, a human petrification ... and without the charm of a friendly germ. No passion, no sense of humor. Happily—they never reproduce and all of them finally go to hell."

Bill Taylor contributed to the Federal Reserve's credibility as a supervisor during times of crisis with firm but fair leadership. He was blunt with the banking industry's influential lobbyists, telling them that "the best

way to get the government out of the banking business is to keep the banking business out of the public's pocket."⁵

Examiners must be able to critically analyze information, ask the hard questions and draw sound conclusions. How focused is our supervision on assessments of risk management more broadly, such as operational and managerial risk? Are we able to judge management and the board critically and assess their attention to process, internal audit, risk appetite and risk management? These are all questions worth asking to make sure we have the appropriate balance.

Finally, I do not believe we have answered the question, to the satisfaction of the taxpayer, "have we effectively addressed too big to fail?" A recent hearing by the House Financial Services Committee examined how the Dodd-Frank Act would prevent future bailouts. The conclusions were less than reassuring.

Whether you judge this issue by size, activities or complexity, we cannot afford to "hope" that Title I (enhanced prudential standards and resolution planning) and II (orderly liquidation authority) will take care of the issue. Too readily, in my view, U.S. policymakers have dismissed proposals to restructure by limiting activities that benefit from public safety nets, to consider size limitations, or to otherwise simplify large complex firms.

In contrast, the U.K. has been more aggressive on this front. Several years ago, Bank of England Governor Mervyn King argued for separating activities, saying "There

⁵ A detailed account of Bill Taylor's career is available from the Kansas City Fed publication, *Integrity, Fairness and Resolve: Lessons from Bill Taylor and the Last Financial Crisis*.

are those who claim that such proposals are impractical. It is hard to see why. ... What does seem impractical, however, are the current arrangements.” Since then, of course, the U.K. commissioned the Vickers report and is in the process of implementing structural reforms. Structural solutions are also suggested in the European Union’s Liikanen report.

Several such proposals have surfaced in the United States, including one by staff at the Kansas City Fed with FDIC Vice Chairman Tom Hoenig that considers altering banking activities and suggests shadow banking reforms.⁶ Further study of such opportunities is surely needed.

Conclusion

Asking “are we on the right path?” may seem an odd question to raise in the midst of volumes of new rules and considerable change in the Fed’s supervision program. But it is absolutely critical that we satisfy ourselves that we can answer the question affirmatively.

As a public institution, our duty is to the American taxpayer. We are obligated to ask ourselves whether these changes have addressed the identified weaknesses that made the taxpayer and economy vulnerable to financial system collapse. Is the financial system better prepared? Perhaps. We should be cautious about accepting relative improvement as sufficient.

Instead, we should step back and ask whether the actions taken to date can sufficiently assure the public that it is shielded “from ever again having to rescue some of the largest

financial institutions in times of economic stress,” as Comptroller of the Currency Tom Curry said in a recent statement.

Only then can we be satisfied that we’ve served the public interest and that indeed we are on the right path.



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The preceding was adapted from remarks delivered at an internal Federal Reserve System meeting on regulatory policy hosted by the Federal Reserve Bank of Atlanta on July 11, 2013.

⁶ Thomas Hoenig and Charles Morris. “Restructuring the Banking System to Improve Safety and Soundness.” May 2011. Available at <https://www.kansascityfed.org/publicat/speeches/Restructuring-the-Banking-System-05-24-11.pdf>.