

Sound Financial Regulation Essential to Sustainable Economic Growth: We Can All Do Better

By William M. Isaac

I have traveled to Asia many times over the past thirty years, and it is my sense that policy makers in Asia tend to look to the U.S. for leadership on financial regulatory issues. This is somewhat unfortunate, as the U.S. has made many mistakes in financial regulation in recent decades. In my view Asia and the rest of the world should not emulate the U.S. but should instead study the U.S. to learn from both our successes and our failures in financial regulation. I hope to provide in this article an objective and candid assessment of U.S. financial regulatory policies.

The period from 1978 to 1993 was tumultuous for the U.S. economy and financial system. The 1970s was a period of low economic growth and high inflation – “stagflation” was the term coined to describe it.

Paul Volcker was appointed Chairman of the Federal Reserve in 1979 with the mandate of getting inflation under control. Volcker, a courageous and principled man, did just that – but at great short-term cost. The prime rate soared to 21 ½% creating havoc throughout the economy and financial system.

The U.S. suffered through a deep economic recession with the unemployment rate reaching 11%. A depression ensued in the agricultural sector along with a collapse in the energy sector and a serious recession in real estate. The thrift industry was badly insolvent, and the deposit insurance agency for the savings and loans was depleted and was merged into the FDIC with U.S. taxpayers absorbing US\$150 billion of losses.

In the middle of all this turmoil, the largest U.S. banks were loaded with loans to lesser developed countries (LDC). The Federal Reserve, FDIC and Treasury developed a contingency plan to nationalize the major U.S. banks if the LDC countries renounced their debts.

Thousands of insured banks and thrifts failed during this period. The seventh largest U.S. bank, Continental Illinois, failed and was in effect nationalized by the FDIC and many large regional banks went under, including nearly all of the ten largest banks in Texas.

Economic conditions in the recent crisis of 2008-2009 were benign in comparison to 1980-1981. And the condition of the banking system was much better in the recent period than in the 1980s – only 519 banks and thrifts failed from 2007 to date in 2014 versus 2,920 from 1980 through 1993.

Yet, the U.S. was able to get through the 1980s without creating panic in the financial markets and without perpetuating economic malaise. In fact, the economy

began the longest peacetime expansion in U.S. history around 1983 even as we continued resolving thousands of bank and thrift failures. Today's economic recovery in the U.S., in contrast, is the weakest since the Great Depression.

How do we account for these differences in results between the two periods? Surely, fiscal and monetary policies and a dysfunctional political system in the U.S. have something to do with it. But without question, regulatory policies also have a great deal to do with both the severity of the crisis in 2008-2009 and the tepid recovery.

I point specifically to the pro-cyclical accounting and regulatory policies the U.S. began to put in place about two decades ago. Sound bank regulation should always be counter-cyclical and lean against the prevailing winds.

The time to be tough on banks and to demand that they increase capital and reserves, tighten credit standards, and slow their growth is when the economy is booming, as it was in 2004-2007. When the economy is struggling, as it has been for the past six years, regulators should encourage relatively sound banks to increase their lending activities rather than making incessant demands for more capital, piling on massive new regulatory burdens, and creating more uncertainty about the future.

I will be more specific. Mark to market accounting was and is a highly destructive force in the banking world. Mark to market accounting requires banks to mark their financial assets to current market prices even when the markets are barely functioning, as happened in 2008-2009. Some refer to it as "fair value accounting" but I refuse to use that terminology because it's not "fair," it adds no "value," and it does not "account" for the actual results of operations. Mark to market accounting needlessly destroyed more than US\$500 billion of capital in the U.S. financial system during 2008-2009 – eradicating US\$4 trillion of lending capacity and creating chaos in the financial markets.

Had mark to market accounting been required in the 1980s, the entire financial system would have collapsed. Surely, nearly every S&L and savings bank would have been shuttered or taken over by the government along with most of the money center banks which were loaded with sovereign loans for which there was no market. Keep in mind that we had nearly 3,000 bank and thrift failures during this period without having to deal with massive paper losses under the accounting rules.

Few people know that the U.S. employed mark to market accounting during the 1930s. President Roosevelt in 1938 asked Secretary of the Treasury Henry Morgenthau to meet with regulators to determine why banks were not increasing their lending and helping the U.S. recover from the Great Depression. They concluded that mark to market accounting was a serious impediment to bank lending and agreed to move to historical cost accounting.

The Securities and Exchange Commission (SEC) pushed the Financial Accounting Standards Board (FASB) to revert to mark to market accounting in the early 1990s, a move opposed by the Federal Reserve, FDIC and the U.S. Treasury. Secretary of the Treasury Nicholas Brady wrote to the FASB on March 24, 1992 opposing mark to market accounting, saying in part: “Market value accounting could even result in more intense and frequent credit crunches, since a temporary dip in asset prices could result in immediate reductions in bank capital and an inevitable retrenchment in bank lending capacity.” He could not have been more prescient.

Despite the abysmal performance of mark to market accounting in the recent crisis, U.S. accountants and regulators refuse to sweep it aside and in fact propose to expand it to include loans, which would have a devastating impact. Let me be very clear: there’s no place for mark to market accounting in banking apart from assets held in trading accounts.

Loans and securities not held in trading accounts should be written down only if there is serious doubt about collection of the full amount of principal and interest. Fluctuations in value due solely to market price movements should be disclosed in footnotes to the balance sheet and should not impact banks’ earnings or capital accounts.

Another major area of concern for me is the Basel capital accords, which rely on exceedingly complex, backward looking models to measure risks and set capital requirements for banks. Basel I (we are now on Basel III) was suggested when I was still Chairman of the FDIC. It sounds good in theory to set capital requirements in accordance with perceived risks, but I had (and still have) major concerns and refused to go down that path.

Models are necessarily backward looking. They cannot see around corners and can only predict the future based upon the past. This means that models are pro-cyclical and accentuate whatever has gone before. Boom times are extended beyond reason as are difficult times. That clearly happened in the 2004-2007 boom period and is happening today in the opposite direction. Moreover, models cannot cope with unknowable factors such as the impact of unprecedented fiscal and monetary policies, military conflicts, political instability, and the whimsical impact of mark to market accounting.

I was also concerned about the temptation the Basel models would create for the governments to use them to allocate credit. My specific concern in the 1980s was that regulators would be under great pressure to underweight politically favored classes of loans such as residential real estate and sovereign loans. This, of course, happened to such a massive degree that these two classes of debt are at the core of the recent worldwide crisis.

Despite their utter failure in the recent crisis, models are being used to an even greater extent today. All banks of consequence are required to allocate capital and reserves and stress test their portfolios based on models. And we continue to have a political debate about how residential real estate and sovereign loans should be weighted.

While models can be useful tools to aid management and regulators, they are no substitute for wisdom, experience, and sound judgment in operating and evaluating a bank. Banks cannot be managed or regulated on auto-pilot. Models must be accompanied by absolute standards for safe and sound banking and by hands-on examination and supervision of banks.

We need a minimum ratio of tangible equity capital to total assets in all banks, and I would set that number at somewhere around 7 or 8%. We need on-site examiners evaluating assets, governance processes including board oversight, management capabilities, and compliance with laws.

In his speech at the Asian Banker Summit in Jakarta last year, FDIC Vice Chairman Tom Hoenig suggested that the U.S. adopt a minimum ratio of tangible equity to total assets as the primary measure of capital adequacy and use risk-weighted capital as a secondary measure to insure that banks do not take excessive risks. I concur wholeheartedly.

Another serious concern is that bank regulation is being made uniform throughout the world. I know this might strike you as a bit odd because it is conventional wisdom that world-wide uniformity in bank regulation is a good thing that will prevent competition in laxity.

While this notion has a certain amount of appeal, it breaks down when the rules of the road are uniformly bad and are set at the least common denominator. If regulators throughout the world are pursuing the same pro-cyclical policies and are employing similar models that underweight or overweight risks and fail to properly account for important macro-economic factors, how will we get out of the global crises we will inevitably create?

The most fundamental risk control element in banking is diversification. Europe cannot help the U.S. right now and the U.S. cannot help Europe because we are both in the same mess at the same time for the same reasons and we are employing the same remedies. I believe the U.S. should focus its attention on getting U.S. policies right, and a good place to start would be rejection of Basel III in its present form.

Banks provide loans and access to capital markets to allow businesses to grow and create jobs and consumers to save, borrow, and make payments. They are absolutely essential to economic growth. People enjoy cursing banks from time to time, but in truth we cannot prosper without them.

There have always been bank failures and always will be. The trick is to allow sufficient risk taking to promote economic growth but not so much that leads to widespread failures and financial panic.

It is clear from the three major banking crises in the U.S. in the past 40 years (1974-1976, 1980-1992, and 2008-2009) that the U.S. has not achieved this balancing act. None of these crises occurred because of lack of regulatory authority but rather the failure of regulators to use their authority effectively to rein in excessive speculation by financial institutions. The U.S. responded to each crisis by piling on more burdensome regulations without addressing the real causes of the crisis or the ineffective regulatory system that allowed it to happen.

The post-Crisis enacted Dodd-Frank legislation in the U.S. is the worst of many bad examples. It is nearly 2,500 pages long and will produce over 20,000 pages of new regulations from the same regulators who presided over the last three major financial crises. Dodd-Frank does not address the major causes of the recent crisis and will not prevent the next one. What regulatory authority did U.S. financial regulators not have to rein in the risks taken by financial institutions that precipitated the latest crisis? I cannot think of any.

It is naïve and contrary to all historical experience to believe that Dodd-Frank and the Basel III capital accords, which significantly increase the cost of capital and regulation to banks and their customers, will solve the problems or will eliminate too big to fail banks. So how do we fix this perennial problem? The solution is a combination of greater market discipline and more effective regulators, not mountains of senseless regulations.

There are three warning signs when an institution, large or small, is approaching the danger zone. We need regulators who have the political will and financial skill to take strong actions when they see these warning signs develop and before they become large enough to crash the system.

The first warning sign is concentration of risk. Most financial institutions fail because their risks are too concentrated by geography, industry and/or product line. A large bank should be able to diversify its risks more broadly than a small bank. Admittedly, if a large bank does not diversify its risks, it can cause considerably more damage than a small bank.

During the 1980's, large Texas banks were among the most profitable and highly capitalized in the U.S. just before nearly all of them failed. They failed because there was no interstate banking at that time and they were highly concentrated in Texas commercial real estate and energy loans.

The second warning sign is inadequate liquidity. U.S. investment banks Bear Stearns and Lehman Brothers reported relatively high levels of capital, but they failed because of insufficient liquidity – the proverbial run on the bank. It is stunning that

those institutions were allowed to operate with balance sheets approaching a trillion dollars funded primarily by short-term liabilities. Inadequate liquidity has been a primary cause of financial failures, forever. Why can't management and regulators get this right?

The third warning signal is significant exposure to capital markets on either the asset or funding side. Capital markets have seized up in the past and will seize up in the future – and it usually cannot be anticipated.

A company that syndicates and sells a large percentage of its loans and other assets is at greater risk of failure than a company that originates and holds its assets. Capital markets can seize up at any time and severely disrupt the business of a company that relies on an originate-and-sell business model, forcing the company to hold loans it has neither the capital nor the liquidity to support. Moreover, with little or no recurring income because originated and securitized assets are sold not held, they have to keep “feeding the beast” – originating and selling more and more regardless of the risks and markets. When this model relies primarily on short-term wholesale funding sources, it is especially toxic – a clear sign to regulators to be vigilant.

Given the long history of financial crises, we should acknowledge that at least in the U.S. regulators are incapable of preventing them without turning banks into government-controlled public utilities that are inhibited from taking sufficient risks to support economic growth. Regulators are being asked to do too much – to carry too much of the burden of controlling bank behavior. We must enlist the marketplace to impose more discipline on overly aggressive behavior by banks.

The U.S. needs a system that assumes failures will occur but are handled in a way that does not devastate the economy or result in taxpayer bailouts. The U.S. must make clear that in all bank failures creditors – other than insured depositors – will face risk of loss so that neither the FDIC nor taxpayers will lose money.

Requiring large firms to increase their common equity capital to breathtaking levels – some people suggest 10 to 20% – is not the answer. That lowers return on equity to the point that banks will be unable to raise sufficient capital and will shrink their balance sheets, impeding economic growth. The very companies and individuals who most need bank loans will be denied access. This is happening in Europe and the U.S. today.

Because equity capital is permanent and cannot declare an “event of default” when it perceives the risks to be excessive, it is only marginally effective in imposing discipline on management. Moreover, equity holders have upside potential and are therefore more tolerant of risk than creditors.

If minimum tangible equity capital were set at 8% of assets and banks were required to issue long-term senior and subordinated debt equal to at least 12% of

assets, it would create a 20% cushion and make it highly unlikely that deposit insurers such as the FDIC, much less taxpayers, would ever incur losses. Moreover, this plan would impose discipline from the marketplace, making failures much less likely. A risky bank would have to pay higher interest on its debt (sending a clear negative signal to management, the board, investors and regulators) and ultimately might not be able to issue long-term debt, forcing it to curtail growth.

When a large bank fails, the FDIC will place it in a bridge bank that will operate under FDIC control with new management and directors. The bridge bank will continue to serve the needs of depositors and borrowers, while leaving the equity, long-term debt, and perhaps a portion of the uninsured deposits behind in a receivership with no guarantee of recovery. The bridge bank will be re-privatized or sold in whole or in part as soon as possible.

In addition to instilling much greater discipline from the marketplace, the U.S. needs to substantially reform its regulatory system at the federal level. There are too many regulators – the Comptroller of the Currency (part of the U.S. Department of Treasury), the FDIC, the Federal Reserve, the Consumer Financial Protection Bureau, the SEC, the Credit Union Administration, the Federal Housing Finance Agency, the Commodity Futures Trading Commission, FinCEN, and the Treasury, among others. Too many things fall through the cracks, the agencies are too politicized and not sufficiently independent, and when the agencies come together for rule-making they generally do so at the lowest common denominator.

I believe the U.S. needs to consider a Federal Financial Institutions Commission that oversees U.S. banks, thrifts, securities and commodities firms, the housing agencies, credit unions, and financial holding companies. The Commission should have a bi-partisan five-member board with fixed six-year terms. The Treasury and Federal Reserve should each have a voting member on the board bringing the total to seven members.

If the Consumer Financial Protection Bureau remains independent, which I believe it should, it would have a non-voting seat on the Commission's board as would a state banking commissioner. I would reform the Consumer Bureau by giving it a bi-partisan five-member board of directors at least one of member of which should be appointed from the Commission's board. Finally, the Bureau's budget should be subject to Congressional approval.

It is essential that the FDIC remain independent to serve as a watch-dog on the Commission. The FDIC would no longer be a bank regulator (approving branches and mergers and other such things) but would continue to have the authority to examine and take enforcement actions against any federally insured institution and its affiliates. The FDIC would also continue to handle the resolution of failing financial institutions. It would be appropriate for the FDIC to have a non-voting seat on the Commission and for a board member from the Commission to have a non-voting seat on the FDIC board.

A regulatory restructuring plan generally along these lines was proposed by Senator Dodd in November of 2009. Unfortunately, Senator Dodd decided to retire from the Senate and dropped his plan in favor of the disastrous Dodd-Frank legislation. More recently, on the eve of the fourth anniversary of Dodd-Frank, former Senator Dodd issued another call for regulatory reform and restructuring.

We also need to focus on mission creep by bank regulators in the U.S. and other countries – mission creep that is diverting regulators’ attention and resources away from their core prudential mission of maintaining a safe and strong banking system. When I was Chairman of the FDIC, the banking agencies developed the CAMELS rating system which measured Capital adequacy, Asset quality, Management capabilities, Earnings performance, Liquidity, and Sensitivity to interest rate fluctuations.

The purpose of this very important endeavor was to bring greater objectivity and consistency to bank supervision. Rather than leaving it to each agency and to each regional office within each agency to decide what prudential standards to impose on the banking industry, uniform, objective, and measureable standards were developed.

The primary mission of the FDIC and other U.S. banking agencies prior to the 1980s was unambiguous - to regulate and supervise the banking system so as to maintain stability and avoid depositor runs and panics. Beginning in the late 1970s, the agencies were asked to also consider how well the banking system was serving customers across the economic spectrum and across racial, ethnic, and gender lines.

The U.S. banking agencies have increasingly lost focus on their primary reason for being and have strayed far from their core missions. One of the most notable examples is introduction of the concept of so-called “reputational risk.” Instead of maintaining laser-like focus on the objective CAMELS ratings, U.S. regulators decided at some point during the past two decades to use undefined, nebulous claims about risks to the reputation of banks to pursue unlegislated social agendas.

No one really knows what reputational risk means beyond the fact that a bank is doing something that a regulator does not like but cannot quantify in terms of risk under the CAMELS rating system. This development has been a major factor in shifting the banking agencies from their primary role as guardians of the soundness and stability of the financial system to amorphous financial social welfare agencies.

I believe firmly that management and the board of directors should be the guardians of a bank’s reputation, not a banking agency. Banking agencies have more than enough on their plates in trying to assess and apply the CAMELS factors. Regulators cannot afford to divert time and energy to assessing potential reputational risks about which their expertise is limited at best.

The measures I am suggesting – smarter and more focused and effective regulation coupled with greater market discipline – will significantly reduce moral hazard, end too big to fail, and make taxpayer bailouts and hopefully banking panics a thing of the past. Dodd-Frank and similar laws around the world need to be replaced with serious reform legislation that addresses the real issues we all face.

I encourage financial executives, regulators, and policy makers throughout the world to view objectively and draw lessons from both the strengths and weaknesses in the U.S. regulatory regime. We can all do better – and our citizens deserve better.

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