Taking On TBTF:

Past Politics to Practical Problems

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Two weeks ago, my firm co-hosted a roundtable at which Senators Brown and Vitter laid out the key provisions of the bill they would introduce the next morning. Tim Pawlenty said in response that – I paraphrase I trust without injustice to Tim – that there's no disagreement between the Financial Services Roundtable or, more generally, the industry over the senators' objective: ending too big to fail. The tricky bit: how to do this.

It's not so easy, as I think a rigorous, objective look at the likely consequences of some pending proposals makes clear. At the end of the day, some of these costs might be worth it if the financial system is truly safer, whether or not the Roundtable or other financial-industry interests agree. But, before we get to this trade-off discussion, we first need to know what the costs really are from a practical, not political perspective. And, for strategic planning, it's vital also to know which pieces of the TBTF "cures" will stick, since these are the ones that will drive policy and profitability at all of your companies.

This morning, I'd like to address a few provisions of the TBTF "cure" that I think will cause perverse consequences not fully considered by advocates of radical reform. I'll shy away from some of the hottest buttons – adverse impact on credit availability, for example – to address some seemingly technical issues with a lot of backfire for each of your firms. Whether or not the Brown-Vitter bill passes – at best uncertain – the issues on which I'll focus are top-priority because many of them could happen with or without new law.

Indeed, as we meet today, one key goal of Brown-Vitter – tough leverage standards – is already ramping up among the regulators. Regulators are also looking at imposing bank-like capital on non-bank activities not just for insurance companies, but now also broker-dealers – a franchise game-changer, in my view. The inter-affiliate transaction provisions in Brown-Vitter are dense, but they're critical – Dodd-Frank also requires toughening these up and, if the restrictions are really ring-fences, the fundamental structural advantage of diversified financial operations, universal banks included, is taken away. This is doubtless what Brown and Vitter have in mind – de facto implementation of the Glass-Steagall Act – but it's a pending initiative with or without them that requires careful analytics and, perhaps, advocacy.

So, what I'd like to do today is look past the compelling political battle over TBTF to its practicalities. Without this, I fear we'll get a financial system that looks tough, but does unanticipated damage to financial-market stability, competitiveness and growth.

Loving Leverage

Let's start with the proposed focus solely on leverage and the Brown-Vitter barriers to continued reliance on risk-based capital. For good measure, the bill bars U.S. implementation of Basel IIII.

Some of you here may well breathe a sigh of relief since there's a lot in the pending NPRs on Basel III I know troubles you. But, wholesale U.S. abandonment of the global regulatory-capital framework would not only isolate the U.S. from the best efforts of committed regulators to level the proverbial playing field, but also spark what has come to be call "re-nationalized" regulation. Less politely, I call this protectionist and I fear a walk from Basel III, combined with final FRB action on its proposed framework for foreign banking organizations, will not only force banking back behind borders, but also scuttle important trans-Atlantic and trans-Pacific trade talks.

A return to leverage also will increase risk – oops! Advocates of a "simple" equity standard like it a lot because there's a lot to loathe in the current risk-based capital rules. As was all too evident in the last few years, "well-capitalized" banks – including those that passed EU stress tests with flying colors – went poof in an instant because they were, in fact, highly leveraged. The Basel Committee itself has found huge variations in risk weightings that undermine the credibility of its own regime.

But, a complete walk-away from Basel I, II and III brings us back to the 1980s, when Japanese banks bought huge blocks of New York real estate without capital to back their bets. Japan is still in the economic slump created by that capital-encouraged debacle decades ago. More recently, the 2008 crisis was in large part caused by the fact that the combination of leverage and risk-based capital rules in the U.S. creates strong regulatory-capital incentives to load up on subprime mortgages and MBS. The cure isn't to go back to leverage – it can never be high enough for some of those assets – but rather to get the risk-based capital right.

I don't have time to go through the rest of the unintended consequences I see with several pending changes to the regulatory-capital scheme. But, to highlight a couple of critical ones for your consideration:

- **Size**: Some of you may not be bothered by Brown-Vitter because your bank is below $500 billion in assets. Think again – the asset measure in the bill is on- and off-balance sheet assets without a lot of netting. So, you are bigger than you think and possibly subject to a far higher leverage capital minimum requirement.

- **Off-Balance Sheet Coverage**: This issue matters not just with regard to the size measurement, but also to the market impact a new leverage standard – by rule and/or law – could have. If off-balance sheet assets are treated just the same as on-balance sheet ones, why use guarantees or similar backstop. This is intended by sponsors of this approach, but it would dramatically restructure an array of financial products, securitization and trade finance first among them in ways advocates may well not like one bit.

And, of course, there's the link between capital and liquidity regulation. Robust regulation requires rules for both of these risks, but we can't have very high leverage

ratios and at the same time expect banks to hold the huge amounts of high-quality, low-risk assets required for the liquidity rules without being crushed by colliding demands and impossible costs.

Broker-Dealers Get the Boot

An important provision in Brown-Vitter is a capital requirement that goes down from the parent level also to demand that its high ratios apply to designated BHC and SLHC subsidiaries and affiliates. Who are these?

Insurance and investment-advisery activities in covered holding companies are out of Brown-Vitter – so good luck to you even though the policy rationale for doing so is nowhere expressed. I know you'll tell me that the rationale for getting you off the hook is that insurance and investment-advisory activities are different than banking. And, so they are. But, then, so are broker-dealers. Why are they required to hold capital as if they were banks?

I've no idea, but I do know the consequences of imposing not just these surcharges, but even due-course bank capital standards to subsidiary broker-dealers – an idea under active consideration at the FRB. Not only does it grievously distort the business model and adversely affect profitability, but it also ignores real risk and, thus, brings me back to the oops factor.

The equity-capital surcharge in Brown-Vitter, just like the simple leverage standard pushed by FDIC Vice Chair Hoenig and others is a credit-risk based model that makes two assumptions I think wrong. First, it assumes that risk doesn't matter when it comes to capital. But, it also bets on the belief that the most important risk comes from making bad loans. This is a significant boo-boo, to be sure. But, it' not the only one that scuttles financial companies.

Operational risk is a serious systemic one – think 9/11, tsunamis, and rogue traders – as is liquidity risk – Lehman, anyone? The more credit-risk capital, the less discretionary resources for the operational controls and back-up systems necessary for operational risk. And, as I said, credit-risk capital, especially at punitive levels actually creates liquidity risk since a simple leverage ratio makes it even harder to hold the large balances in Treasuries and similar low-risk assets needed to meet the new liquidity standard.

A monomaniacal focus on credit risk for banks is bad enough. But, for non-bank activities, it's downright perverse. What's the risk in a broker-dealer? Credit risk? I think not if the broker-dealer is doing what it's supposed to do: executing trades for third parties and principally taking settlement risk. There's a bit of credit risk there, to be sure, but the bulk of broker-dealer risk is operational risk, as well as reputational risk resulting from internal fraud or improper use of customer assets. Is even fifteen percent of equity enough to quell these risks? I don't think so, especially since the requirement actually

takes resources from meaningful risk mitigation that ensures real customer and systemic protection

So, here's another perverse result: riskier capital markets because a key link in them – broker-dealers – are forced to hold huge amounts of irrelevant capital that makes them operationally vulnerable.

Riding the Ring-Fence

Finally, let me turn quickly to the inter-affiliate transaction issue. Those of you that have labored in the 23A and 23B vineyards know well how complicated this is, and also how vital these complex rules are to the structure of bank holding companies. The more ring-fenced a bank is from non-banking activities, the less value it has to those non-bank activities from a funding, capitalization, credit-support and many other perspectives. One reason universal banking organizations have grown so large and engaged in so many business lines is the fundamental value – opponents would say subsidy – an insured depository or backstopped bank gives all these non-banking activities.

Cut them off and, with it, curtail the structural bulwark of universal banking, as well as the cross-cutting economies in any securities, insurance or asset-management firm with a bank subsidiary. This may be warranted from a public-policy perspective, but not if it's done haphazardly.

For example, Brown-Vitter clearly covers member banks, permitting thrift benefits to flow through a holding company and, perhaps, allowing this also for state non-member banks. Since lots of other firms that own banks – GE, for example – are exempt from all of its terms, the extent to which inter-affiliate restrictions apply to them is, at best, uncertain. Thus, a policy goal comes aground on practical reefs.

Even more troubling, if one curtails these inter-affiliate transactions, does it make the system riskier? I can think of all sorts of things housed in banks, especially national banks, that aren't anything close to traditional banking. Do these get ring-fenced to and, if so, how? If not, doesn't this create a strong incentive for BHCs to put as much as they can within the bank, not in BHC subsidiaries – essentially bringing the U.S. as close to the EU universal-bank model as firms fearful of lost franchise value can get?

The Oops Factor

A fundamental treatise in decision theory comes from Robert K. Merton, who laid out what he called "the law of unintended consequences." A cliché now, perhaps, but a fundamental prism through which every policy proposal should be assessed before we barge on in.

With this in mind, I took a first crack at an analytical landscape on the Brown-Vitter bill's initial draft, a landscape I know you have been given in your conference materials. My goal here was not to evaluate or prioritize the bill's possible consequences. Note, in fact, that the right-hand column on the landscape says "possible consequences," not unintended ones. I did this to lay out as objectively as I could the plusses and minuses of key provisions as I knew them then to be.

I welcome any questions you have on the landscape, which goes into detail on key points not just in Brown-Vitter, but also on initiatives now pending at the FDIC, FRB and OCC. I've gone beyond it today to focus on three key issues – leverage capital standards, application of bank capital rules to non-banks and inter-affiliate transaction constraints. But, there's lots more not just in the Brown-Vitter bill, but also on the regulatory landscape. Thus, I would be happy to answer questions on any of these other issues – all have, I think, the potential to make our meeting next year a very sober affair.