# *FedFin Daily Briefing*

**Tuesday, September 20, 2016**

## Loss of Large-Bank Franchise Value Poses Growing Risk

In this alert, we analyze an influential paper released late last week by former Treasury Secretary Summers and Natasha Sarin of Harvard arguing in part that the largest banks are not safer than they were before the crisis – indeed, perhaps even riskier – despite all the new regulations. Taken by some as a call for still tougher rules, the paper in fact suggests that still higher capital standards or more stringent stress tests could backfire by making large U.S. banks even riskier. This conclusion is based on the measures used to judge bank risk – principally market capitalization and certain risk spreads – most of which show that investors do not reward U.S. banks for all the new rules. Although some academics have suggested that investors do reward banks for resilience through reduced cost of capital, we have long asserted that investors invest in banks for the same reason they invest in light-bulb companies: to make money. Since the new rules reduce the capacity of large banks to earn market-competitive returns, investors reduce their equity holdings and, as they do so, the Summers paper recognizes that this higher leverage in terms of market equity makes banks riskier in terms of the potential for failure regardless of regulatory measures.

The paper's conclusions are based on a fundamental premise: that "the view that banks are safer and less likely to fail is essentially an assertion that market value is less likely to approach zero." Regulators do not measure bank resilience this way and critics have questioned it on grounds that, read literally, it would mean that banks were safer in 2007 than 2016 due to higher equity book prices. We would concur with critics of this approach to the extent that variations in market cap do indeed reflect an array of market factors with little relation to long-term safety and soundness (for example, market equity may improve as rates rise without any relationship to prudential risk). However, as the OCC's latest supervisory manual and recent statements from foreign regulators indicate, banks with diminishing franchise value face long-term sustainability challenges with severe and adverse prudential impact. By taking this on, the Summers and Sarin paper thus takes a new direction with considerable implications in a Clinton Administration.

The paper includes another key point: investors are not rewarding banks for the cost of higher capital. The paper presumes that investor skepticism derives from continued market-risk assumptions, thus linking the cost-of-capital point to market valuation, but we note that it can also be attributed to investor perceptions that highly-capitalized banks cannot generate the returns sufficient to meet investor needs, needs which can be met by other investments even though investors usually recognize that this involves greater risk.

To reconcile its findings that markets view banks as risky even though new rules make them safer, the paper posits that the new regulatory-capital standards are poor measures of actual economic risk. It prefers market equity to regulatory capital as a measure of bank resilience.

Despite its high-level assertion, this analysis also concludes that the largest banks may in fact be safer since the crisis because smaller market capitalizations in relation to assets means less likelihood of failure due to the insulation of market valuations from proportionate asset loss. This is essentially a utility model of market valuation and could prove correct over time for the largest banks if investors come also to expect utility returns. However, as noted, indicators assessed in this paper note that lower market values are not in fact offset by lower equity and related pricing, making it at best uncertain if larger U.S. banks will restructure into utilities and retain their viable franchises.

Interestingly and importantly, this assumption also underlies recent research by Mr. Summers' Harvard colleague, former FRB Gov. Stein. As we noted in reviewing that paper, it posits utility-style large banks with monetary-policy transmission principally accomplished through non-banks. The paper may be found at https://www.brookings.edu/wp-content/uploads/2016/09/2_sarinsummers.pdf.

## Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing info@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about *GSE Activity Reports*, click here.

- **USG3:** Treasury is seeking primary-dealer views on issuance practices stemming not from Treasury concerns about the shape of U.S. interest rates and government spending – the usual drivers of changed issuance patterns – but rather those due to the cost of new prudential regulations.
- **INFOSEC26**: The FDIC, FRB, and OCC today released a joint ANPR requiring enhanced cyber risk management at large banks and holding companies, FBOs over the $50 billion threshold, designated SIFIs, financial market utilities (FMUs), and financial market infrastructure (FMIs) supervised or operated by the Federal Reserve.
- **ALLL2**: Both international and U.S. accounting-standards setters have adopted requirements altering the requirements for loan-loss reserving from the pre-crisis "incurred" approach to one based on "expected" loss.
- **INCLUSION2**: The Basel Committee has finalized proposed guidance laying out global standards to ensure safety and soundness as well as consumer protection as efforts are made to ensure that financial services reach those previously excluded from the savings and transaction services necessary for wealth accumulation and social stability.
- **LIQUIDITY28:** The SEC today unanimously finalized its proposal (see FSM Report LIQUIDITY22) for liquidity risk management at open-end funds and separately approved by a 2-1 margin a rule permitting certain open-end funds to utilize swing pricing.
- **RESOLVE41:** The OCC has finalized a proposal establishing enforceable standards requiring national banks and other institutions under its authority with assets over $50 billion to ensure resilience under operational risks such as cyber-attacks as well as their resolvability in the event these or other risks threaten viability.

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