





The Wrong Lessons

The financial crisis of 2008 has sparked a debate about what capital standards should pertain for financial institutions. The Obama administration, the G20 leaders, bank regulators, and some legislators are calling for financial institutions to hold more capital because they view insufficiency of capital as one of the principal causes of the financial crisis. **Paul Atkins** examines whether this approach stands up to scrutiny.

BASEL CAPITAL STANDARDS

Ironically, regulatory and legislative attention for much of the time leading up to the financial crisis was focused on revamping capital standards. Regulators recognised in the 1970s that globalisation of the financial services industry demanded a more coordinated approach among regulators, particularly to avoid jurisdiction shopping by multi-national banks. Thus, Basel I was born in 1988, taking effect in 1992, but it proved not sophisticated enough to deal with the increasing complexity of financial products.

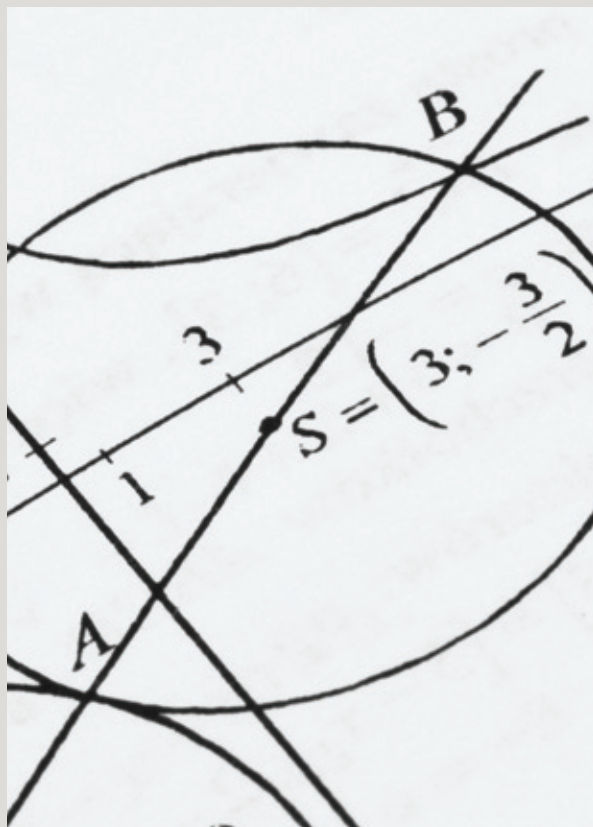
Basel I was intended to create a risk-based approach to capital regulatory standards – giving credit against capital allocations based on general asset categories. Under Basel I, assets of the same general type would be classified into broad buckets

(e.g. government securities, residential mortgages, corporate debt), even though the individual securities had differing risk characteristics.

This system had the unintended consequence of driving banks to riskier assets, because less risky assets within a category would count the same against capital as riskier assets within the same category. Since riskier assets generally pay better returns (at least on a non-risk weighted basis), banks could get a bigger bang for their capital buck.

As a result, Basel II was developed to address these anomalies with a complex set of new standards. Basel II is based on three “pillars”: Pillar 1, which attempts to move away from Basel I to more accurately calculate minimum capital requirements for credit, market, and operational risk, using banks’ internal value-at-risk models; Pillar 2, which relies on regulatory supervisors’ review of capital adequacy to assess things not included in Pillar 1, such as internal controls, quality of management, concentration of assets; and Pillar 3, which strives for motivating good risk management through disclosure and market mechanisms. Significantly, Basel II never imposed a leverage ratio limit.

Basel II suffers not only from a complex framework and difficult implementation issues, but also from a lack of transparency. Pillar 1 has many inputs that are not disclosed publicly, actions by regulators under Pillar 2 are typically not disclosed, and disclosures under Pillar 3 are not consistent across banks. Although controversy in the United States has delayed its adoption there, the European Union swiftly implemented the new standards in late 2006.



The attempt to control information under the safety and soundness watchword of banking regulation has been shown to be a complete failure. In the globalised modern financial world, where money can flee in seconds, transparency is key and market discipline is the only real solution.

Capital is the foundation of any financial institution. From the perspective of bank investors, idle funds are not necessarily an efficient use of resources because they are not employed in the business goals of the organisation.

But capital is necessary for confidence of depositors and counterparties because it cushions unanticipated losses and gives some assurance of solvency. With central banks and now even governments as lenders of last resort, capital is also a tool for regulators to influence risk-taking by regulated institutions, effect monetary policy, and protect against systemic risk. That is, if they can perceive the risk.

Clearly, autumn 2008 blew a hole through each of these putative reasons for capital. Some of the largest and most sophisticated international banks in the United States and Europe failed or were bailed out by their

governments as depositors ran on the bank. These banks had more than “adequate” capital as measured by standards that had been in existence for almost two decades.

They were also heavily regulated, with the largest ones having full-time government examiners monitoring all aspects of the bank’s operations. Even the largest US investment banks, labelled by some as the “gamblers” of the financial world, exceeded the minimum international capital standards for banks.

The lesson drawn from the events of the last year by many politicians and regulators is that the existing capital regime is inadequate and has to be overhauled. They have already started taking steps to do so. To illustrate the speed and scale of these efforts, it took regulators 12-15 years to modify the Basel I accord into Basel II. Today’s reform efforts propose sweeping, structural changes to be devised and

agreed upon in only 18 months, with the bulk of the requirements to take effect in 2012.

Last September, leaders of the G20 affirmed recommendations made by the Basel Committee on Banking Supervision for changes to improve the quality and quantity of bank capital, such as imposing increased capital levels, leverage restrictions, and liquidity requirements on banks; minimising the “pro-cyclicality” of regulatory standards; and potentially requiring greater capital levels from “systemically important” institutions. The Basel Committee is expected to release new consultative papers expanding upon these recommendations.

While the Basel Committee completes its work, regulatory and industry attention is focused squarely on how American regulators will respond to these issuances and propose to modify bank capital rules. Three

SEC CAPITAL STANDARDS FOR INVESTMENT BANKS

On the investment banking side, the SEC in 1975 adopted a net capital rule that it hoped would ensure that troubled broker-dealers would meet their obligations. At the time, operational problems in the late 1960s and the bear market of the early 1970s had led to a large shake-out of broker-dealers, and the SEC was determined to bring some order to the liquidation process. The net capital rule uses a haircut system to calculate minimum capital requirements. The 1975 rule actually laid the groundwork for the credit rating agencies' eventual oligopoly, since the level of credit towards capital assigned to a particular security depends on its credit rating.

Whose ratings were deemed acceptable? The answer: only those from certain, specially designated credit rating agencies. In a very non-transparent process that survived until Congress finally forced the SEC to change it in 2006, SEC staff would designate acceptable firms without any formal procedure; the Commission itself was not even part of this informal process. One firm languished more than 15 years before it was found acceptable. This system decreased competition in the credit rating business, which fostered the conflicts of interest and other problems particularly with regard to ratings of structured financial products.

Some have charged that the SEC's supposedly "deregulatory" policies under the Bush Administration allowed US investment banks to use unprecedented leverage ratios leading up to the financial crisis.

In any debate, it helps to check the facts, and careful analysis of the data does not support this contention. Indeed, in 1980 (only five years after adoption of the net capital rule) the SEC noted that the leverage at investment banks had increased from around

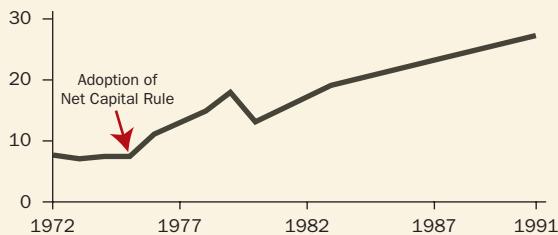
7:1 to 18:1. By the early 1990s, the largest investment banks had leverage ratios of more than 30:1. (see Table 1)

The particulars of the net capital rule help to explain these facts. The SEC traditionally focuses on the safety of customer assets. The SEC net capital rule allows brokers to use a "basic" method, or an "alternative" method, for calculating liquid assets necessary to cover the firm's receivables from its customers. The basic method, which hundreds of mainly small brokers use, limits leverage to 15:1, but this computation applies only to unsecured debt. Brokerages fund themselves predominantly through secured borrowing.

To use the alternative method, which only the largest firms do, a firm must institute costly, stringent procedures for reporting and segregation of customer assets. The alternative method never imposed a leverage limit. Thus, with secured debt excluded from one computation and no leverage calculations under the other method, the 1975 net capital rule effectively never imposed a leverage restriction.

Moreover, seldom does the debate about capital levels prior to the financial crisis

CHART 1 – BROKER DEALER LEVERAGE (1975-1991)



Note: Leverage ratio defined as total liabilities/total equity. Since leverage data is not made public, data is not available for all years (1981 and 1984-1989). Sources: For 1972-1979, SEC Release No. 34-17208, 45 Federal Register 69915, October 22, 1980. For 1982-1983, Molinari/Kibler Financial Responsibility cites a Lipper study that "industry leverage increased from 17:1 in September 1982 to 19:1 in September 1983." For 1980 and 1990: GAO Financial Activities Report at 40-41, studying thirteen of the largest broker-dealers' leverage ratio.

TABLE 1

	Senate Banking Committee: “Restoring American Financial Stability Act of 2009”	Treasury Department: “Financial Regulatory Reform: A New Foundation”	House Financial Services Committee: “The Financial Stability Improvement Act”
Heightened Standards for Large Firms	Stricter prudential standards include leverage ratio, liquidity requirements, credit concentration and risk management, as well as reporting and disclosure. Includes new contingent capital requirement.	More robust capital requirements and stricter liquidity, counterparty and credit risk management requirements.	Similar tiered structure for increasingly large financial institutions. No contingent capital requirement (long-term hybrid debt that converts to equity).
Systemic Risk Regime	New <i>Agency for Financial Stability</i> to impose higher standards on systemically important firms; chaired by a presidential appointee, and includes heads of the other regulatory agencies.	A council of regulators to monitor the economy for systemic risks and for the Treasury to decide if a firm has become so risky that it must be wound down.	For “identified financial holding companies”, a systemic risk council chaired by the Treasury Secretary identifies systemic risks. Federal Reserve would execute its decisions.
Bank Oversight	Super-regulator called <i>Financial Institutions Regulatory Administration</i> would consolidate bank oversight authority.	Merge OTS and OCC, but largely leaves the authority of the Federal Reserve intact.	Multiple existing agencies, particularly the Fed and FDIC, retain limited and distinct regulatory functions.
Federal Reserve	Removed of all authority beyond determining monetary policy, and serving as the lender of last resort.	Made the regulator of large companies whose leverage and complexity threaten the financial system as a whole.	Authority to oversee and restructure large financial firms; Increased authority to police systemic risk to the economy
Resolution Authority	<i>Systemic resolution fund</i> created with payments from systemically important firms to fund the winding down of insolvent institutions. Requires a “living will” to be drawn up.	The FDIC would have the power to resolve or dismantle companies near default. The large financial firms that are still standing would be charged fees to cover the costs of the company that was resolved.	Same as Senate bill – <i>Systemic resolution fund</i> pre-funded with payments from systemically important firms to recoup taxpayer costs of future bailouts.
Credit Rating Agencies	Allow investors to sue ratings companies for negligent ratings. Let the SEC revoke the registration of a ratings firm for “bad ratings”.	Create an office within the SEC that will supervise credit rating companies.	Allow investors to more easily sue credit-rating companies.

mention that the large US investment banks were also subject to Basel II capital standards, and in fact exceeded them.

In 2004, the SEC introduced a new alternative net capital computation – essentially Basel II – for the largest broker-dealers who elected to be supervised under the SEC’s new “consolidated supervised entity” (CSE) programme.

This programme was created in response to the EU’s 2004 Financial Conglomerates Directives, which required financial conglomerates operating in Europe to have a regulator supervising the consolidated entity. If they lacked one, a European regulator (in this case, the UK’s FSA) would fill that role, raising the likelihood of duplicative or conflicting regulation.

At the time, the SEC clearly was not a consolidated supervisor, because its statutory authority extended only to US broker-dealers and not to the holding companies operating on a global basis. Because the SEC lacked

clear statutory authority to undertake the CSE programme, it was made available to the large investment banks on a “voluntary” basis.

In fact, the programme was anything but voluntary for the firms that enrolled, because by withdrawing they would become immediately subject to the EU Conglomerates Directives and FSA oversight over their entire operations, with the added costs, bureaucratic hassles, and jurisdictional conflicts that might entail.

Voluntary or not, the programme introduced for the first time the ability for the SEC to monitor the holding company level and required CSE firms to notify the SEC if net capital at the holding company level fell below \$5 billion. Hence, far from supposedly eliminating leverage restrictions – which effectively did not exist under the net capital rule, and were never part of Basel II – the 2004 CSE programme actually provided some level of oversight where previously there was none, especially in the context of a legislative vacuum.

bills are pending before Congress which would change various aspects of the financial regulatory structure.

There are many differences among the competing legislation, but common policy objectives include greater oversight of system-wide risks, reorganisation of the bank regulatory agencies, new rules regarding credit rating agencies, and new tools to wind down failed (or even healthy, but large) institutions. It is impossible to predict which, if any, of these items will eventually be enacted into law.

While the specifics regarding capital standards continue to be worked out, it is likely that regulators ultimately will require banks to hold more common stock as Tier 1 capital, and for Tier 1 capital to constitute a “large majority” of a bank’s total regulatory capital. The ability to include hybrid instruments, such as trust-preferred securities, in Tier 1 may also be restricted.

As the economy recovers, regulators may coordinate their efforts to require banks to keep contingent capital reserves. Historically, the issue of reserves has pitted bank regulators – seeking safety and soundness and thus higher reserves – against the SEC, which has concerns about potential earnings manipulation.

It seems clear that regulators have bought into the conventional wisdom that capital levels before September 2008 were partly to blame for the ensuing disaster and that a significant heightening is necessary to prevent a repeat.

Unfortunately, it appears that they have taken away the wrong lessons. Does anyone really believe that increased capital would have prevented the collapse of Bear Stearns and Lehman’s? What led to failures at financial institutions was to recognise

the inadequacy of their own risk management systems and strategy in time to avert a collapse? How did many investors get lulled into complacency and not adequately do their own due diligence? More to the point, what led to the failures of regulatory agencies around the world to discern the increasing risk to financial institutions under their jurisdiction?

First and foremost, in the globalised modern financial world, where money can flee in seconds, transparency is key and market discipline is the only real solution. People fear what they do not know. With respect to banks, the attempt to control information under the safety and soundness watchword of banking regulation has been shown to undermine investor confidence – and capital cannot make up this deficit.

The system in which regulators keep valuable information from the markets actually propelled the uncertainty in the autumn and winter of 2008, leading to an extreme lack of confidence. Market discipline is the worse for this regulatory sangfroid, where even underwriters doing due diligence for an equity offering have no access to bank examiner reports.

High leverage may have been prevalent, but it was not the fundamental cause of the crisis. Practically speaking, no amount of capital can safeguard against panicky investors, customers, and counterparties when risk assumptions are not priced appropriately. Leverage ratios are meaningless in and of themselves – equally important is the risk-adjusted value and quality of the underlying assets.

Understandably, regulators, legislators, and the public are looking for quick and easily implementable solutions. In the rush to effect lasting

reform, misconceptions regarding the history of investment bank leverage and capital levels have coloured the approach, just as incorrect credit ratings created the rose-coloured eyeglasses through which regulators, firms, and investors misperceived risks inherent in the holdings of financial services firms.

Contrary to conventional wisdom, leverage of the European banks in 2008 at more than 40:1 was about twice as high as that of US investment banks. Perhaps even more surprising to some, unregulated hedge funds had even less, at 2:1 overall.

The success of the current regulatory reform agenda and the financial system as a whole depends on sound and stable principles – namely transparency, accountability, and predictability. Any proposals prescribing for the regulator of the future a role to be able to see farther, think more clearly and predict the next bubble in time to take effective action are ultimately impracticable, because one man’s bubble is another man’s livelihood. Thus, political and institutional realities make timely action exceedingly difficult – even for the bravest of regulators.

It is imperative that regulators and legislators study carefully the causes and triggers of the financial crisis. In the US, Congress has established the Financial Crisis Inquiry Commission, with a hefty budget and subpoena power to look into these issues. Many universities and thinktanks also are pursuing their own analyses.

Only with clear thinking and solid information – and, frankly, a little space for reflection – will we be able to build a strong foundation for our financial markets, and not just apply bandages and palliatives to cover up the makings of the next crisis. **Q**