Reforming Financial Regulation After Dodd-Frank

Charles W. Calomiris
Columbia Business School

How should one evaluate Dodd-Frank?

Newspapers and politicians tend to focus (from customer perspective) on the cost of services, the availability of services, and (from the perspective of the industry) on stock values, entry, and growth.

Such evidence provides a very negative picture: declining market share for small banks, lack of entry, low market-to-book values, higher fees (service fees up 111%), weak loan growth for small and medium-sized businesses, more unbanked Americans, declines in credit card accounts (15%).

But this is an incomplete picture: Is the system safer, and by how much? Other costs and benefits of regulation (consumers information, fair regulatory and supervisory processes)?
Are adverse trends the result of regulation, or some other influences?

Approach taken in this book

Are intended goals of specific regulations achieved, and likely to be achieved in future? Has risky mortgage lending been prohibited, as intended? Are capital and liquidity regulation measuring risk and capital properly? Is macro-prudential regulation working to reduce systemic risk?

Are regulatory costs creating major distortions in the financial system? Is regulation causing declines in overall lending, in the areas that have been highly regulated (credit card lending), and declines in bank growth and entry?

Regulatory process achievements: Are the changes consistent with due process, rule of law, fair treatment?

Findings and directions for change

- Along all three dimensions regulation has been a flop. We are paying high costs and getting little in return.
- Achievements are absent or small. (I will review these in detail.)
- Costs attributable to regulation are substantial (reduced entry, consolidation, growth, and lending, as shown by Bouwman et al. 2017a, 2017b, Acharya et al. 2017, Allahrakha et al. 2017, and many others).
- Changes in regulatory process (reliance on guidance, unlimited discretion) add to regulatory uncertainty, produce unfair treatment, and undermine due process and rule of law.
- These failures reflect an unprincipled and unrealistic approach, which invites incoherence, political abuse, and regulatory failure.
- What principles should guide us?
- What new approaches to regulation would conform to those principles and be likely to provide more benefits, less costs, and better processes?

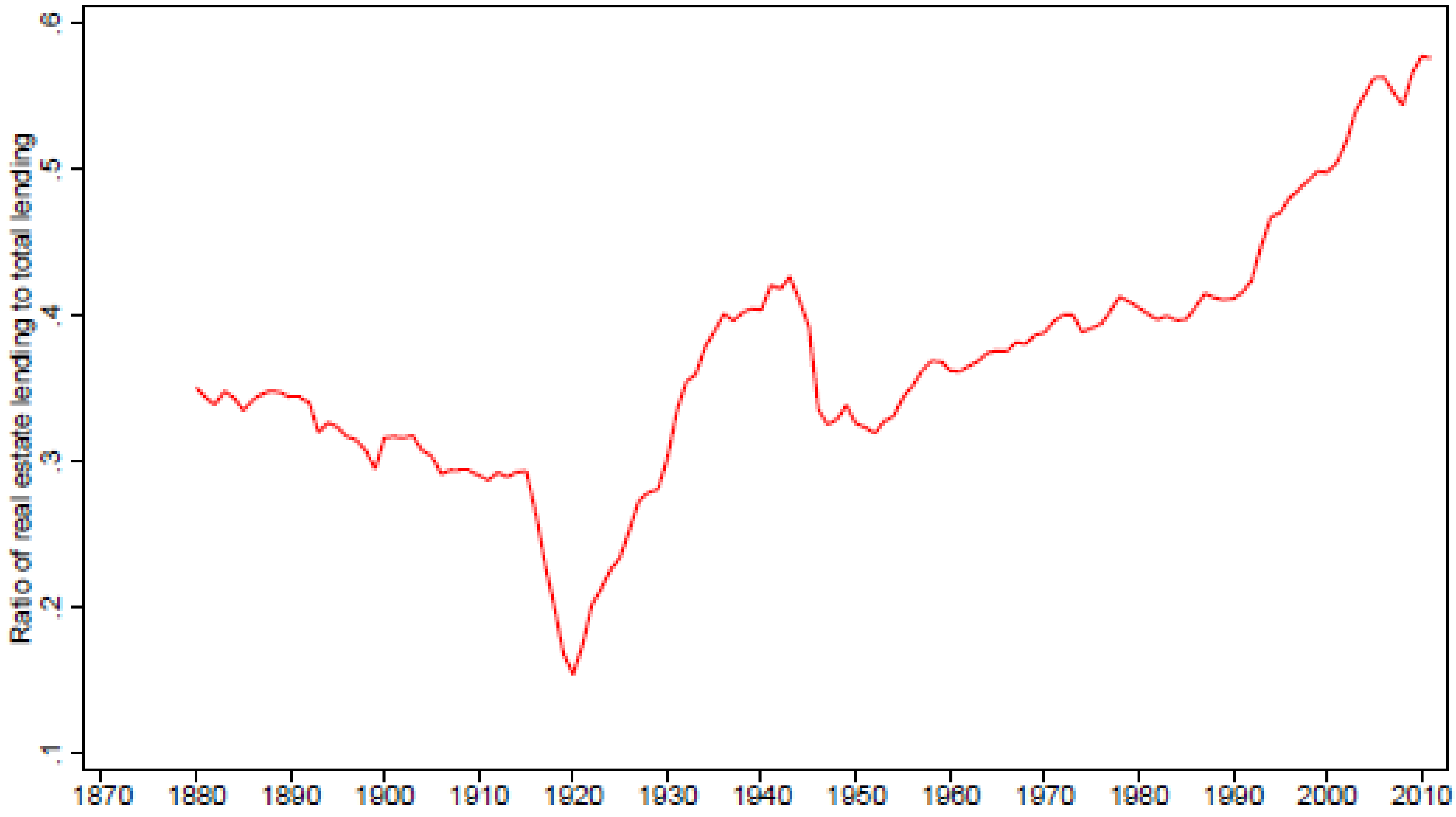
Mortgage risk regulation (QM and QRM)

- QM safe harbor for Truth in Lending.
- QRM "skin in the game" requirement.
- Both were watered down substantially by lobbyists ("Coalition for Sensible Housing Policy," which consisted of urban activist groups and housing industry), and more importantly, both were undermined by GSE exception (what Barney Frank called the "loophole that ate the standard"), which was made worse by the debasement of GSE standards since 2013 (Mel Watt and 3% down payments), which also has given the GSEs and FHA a near monopoly of the mortgage market. (See Gordon and Rosenthal 2017).
- Mortgage risk has risen dramatically since 2013 (AEI mortgage risk index). As of January 2017, 28% of first-time buyers have debt service-to-income ratios above QM limit of 43%. The main problem that created the crisis of 2007-2009 has not been solved. Moreover, housing is very expensive (leverage subsidies drive up housing prices), and access to affordable housing is low.

Global Boom in Bank Mortgage Lending

- Post-1970 global boom in risky mortgages (Jorda et al. 2016a).
- Real estate lending by U.S. banks was considered inappropriate, banned for national banks until 1913. Great Depression's push for subsidized housing finance (Fannie Mae and FSLIC). Insurance companies and building and loans had specialized in mortgages, which were not less risky and funded by equity and long-term debt (Fleitas, Fishback and Snowden 2016).
- Recent banking crises often due to real estate (Jorda et al. 2016b).
    - Subsidized, cyclical, hard to liquidate in a downturn.

Figure 4: Aggregate share of real estate lending in total bank lending



Notes: Share of real estate lending to total lending averaged across 17 countries. Before 1880 the sample size is too small for use. See text.

Connecting protection of banks and RE risk

- Deposit insurance w/o adequate regulation subsidizes risk.
- These rents may be created so that they can be distributed to targeted borrowers.
- Calomiris and Haber (2014) show that the Game of Bank Bargains is mainly about rent seeking by borrowers.
- To target rents to housing, you have to create rents.
- Both deposit insurance and real estate risk subsidies share a desirable feature: off-budget, hard-to-trace policies (easier for Republican Presidential candidates, and influential urban Republicans – such as Newt Gingerich – to support them).

Connecting DI and RE: Calomiris and Chen (2017)

- Problem of endogeneity.
- Instrumenting using outside influences on starting or expanding deposit insurance.
- World Bank’s, IMF’s, EU’s, other countries’ effects on subject country’s protection of its banks.
- Instrumented generosity of deposit insurance protection predicts bank risk taking, and also the proportion of loans in mortgages.

Cournede and Denk (2015)

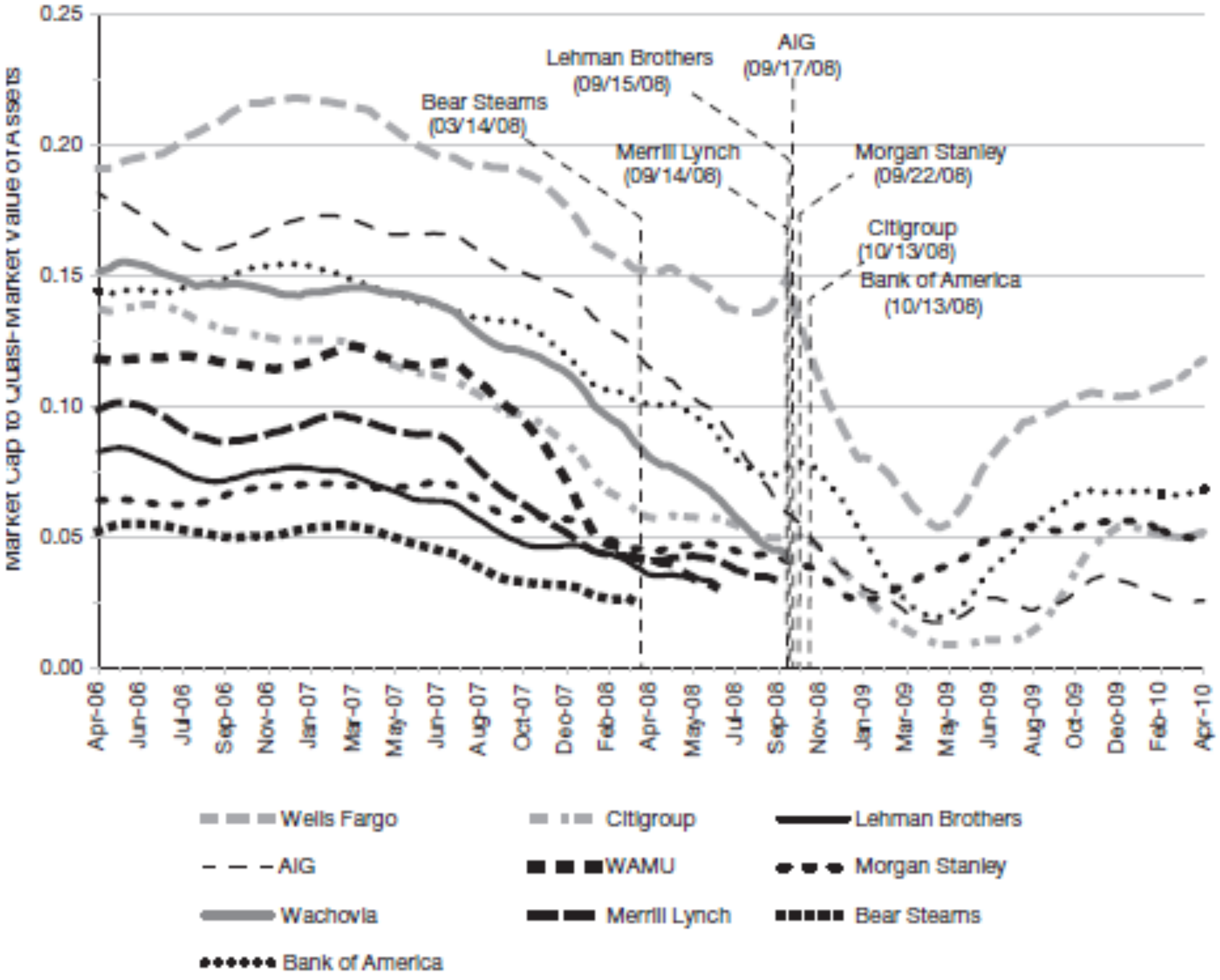
- On average, intermediated credit is associated with negative growth, which reflects the influence of countries with above 90% credit/GDP, which dominate their OECD sample.
- These results are driven by the increasing importance of household borrowing, which is crowding out borrowing that spurs investment.
- Interpretation: Government policies distorting credit allocation toward households (recall rising mortgage credit share) are making bank credit less conducive to growth.

Capital regulation

- Multiple potential bindingness (risk-based standards, leverage standard, SAR, Stress Tests) => uncertainty.
- Doubling down on book capital and risk-based asset measures (Citibank's 12% capital ratio in December 2008).
- Risk weight measures are easily arbitraged (Plosser and Santos 2016, Behn et al. 2016).
- Book capital is not economic capital (Calomiris and Nissim 2014).
- Stress tests are secret (quantitative and qualitative standards) and thus not accountable. Neither are they based on loss of value measured by proper use of managerial accounting.
- Capital regulation affects loan supply (Acharya et al. 2017, Allahrakha et al. 2017).
- OTC market making is affected by leverage limits (and liquidity regs).
- But those costs are not offset by a likely benefit: The same problems that occurred in 2006-2008 are likely to occur again. In the meantime, uncertainties also make costs unnecessarily high.

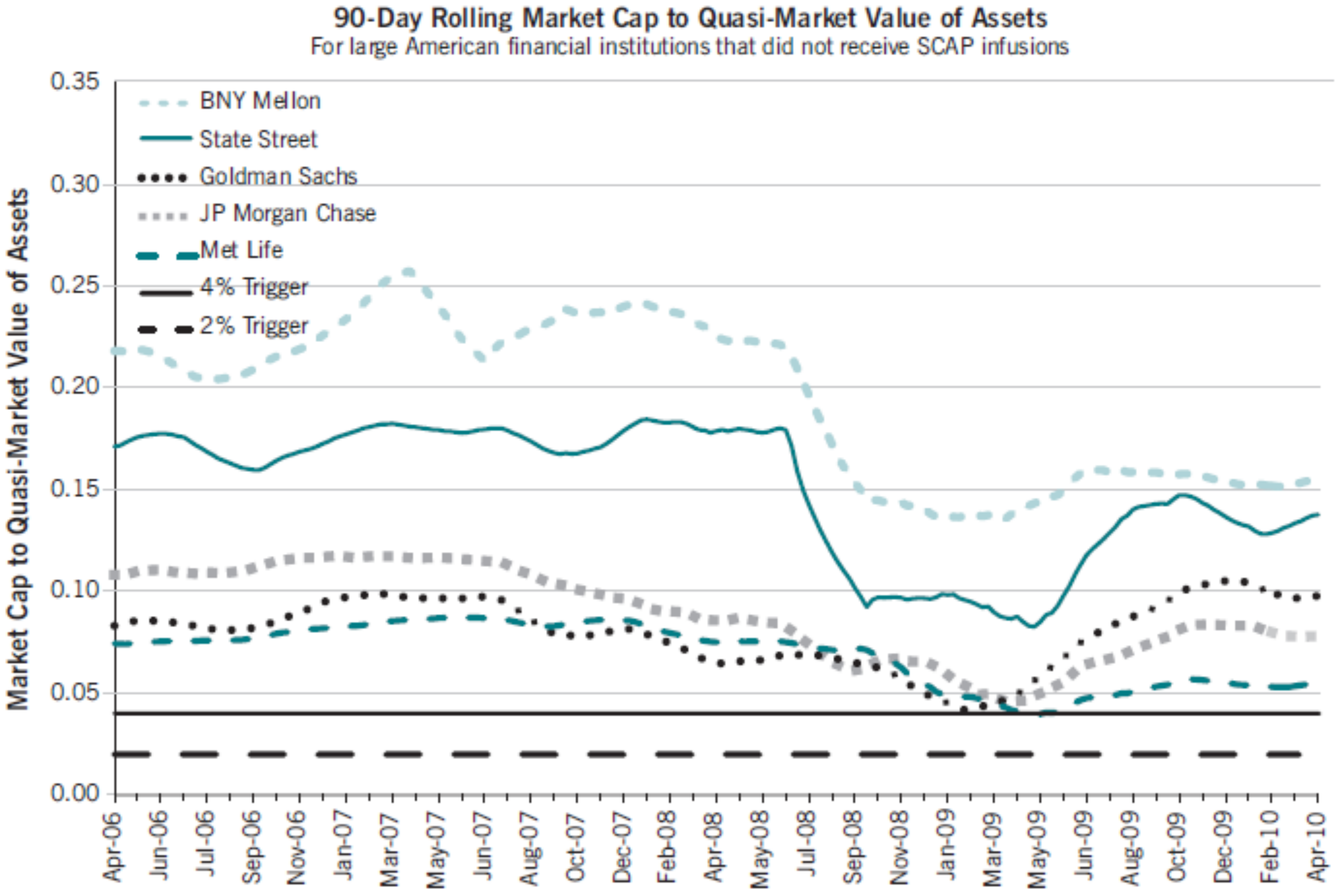
Figure 1. 90-Day Market Cap to Quasi-Market Value of Assets

U.S. SIFIs That Failed, Were Forced into Mergers, or Received Major SCAP Infusions



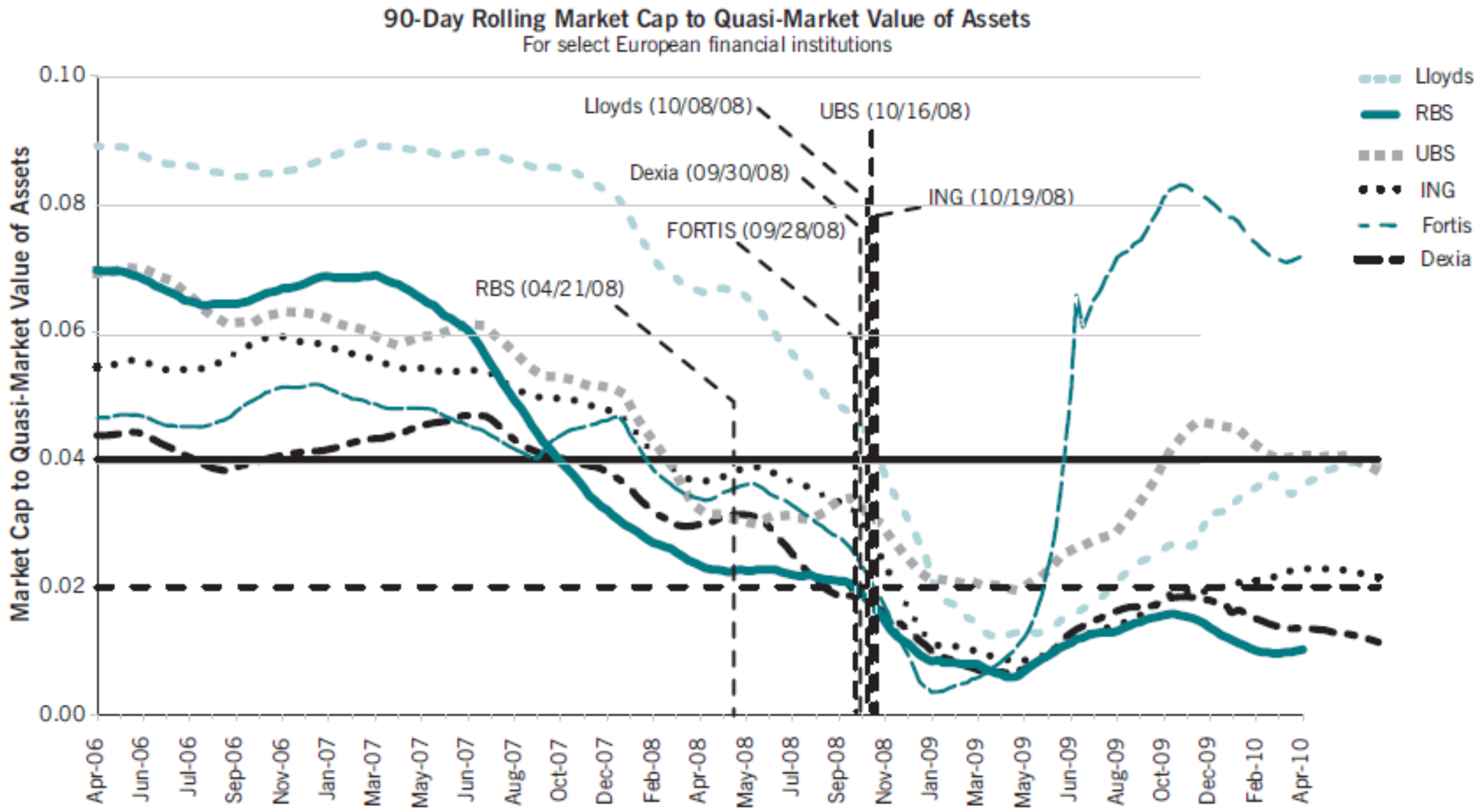
Source: Calomiris and Herring (2013), Figure 4. Note that because the plots represent 90-day moving averages, they provide a lagging picture of the timing of actual market declines.

Figure 3 **Ratio of the Market Cap to the Quasi–Market Value of Assets for the Five SIFIs That Did Not Require Substantial Government Intervention, April 2006–April 2010**



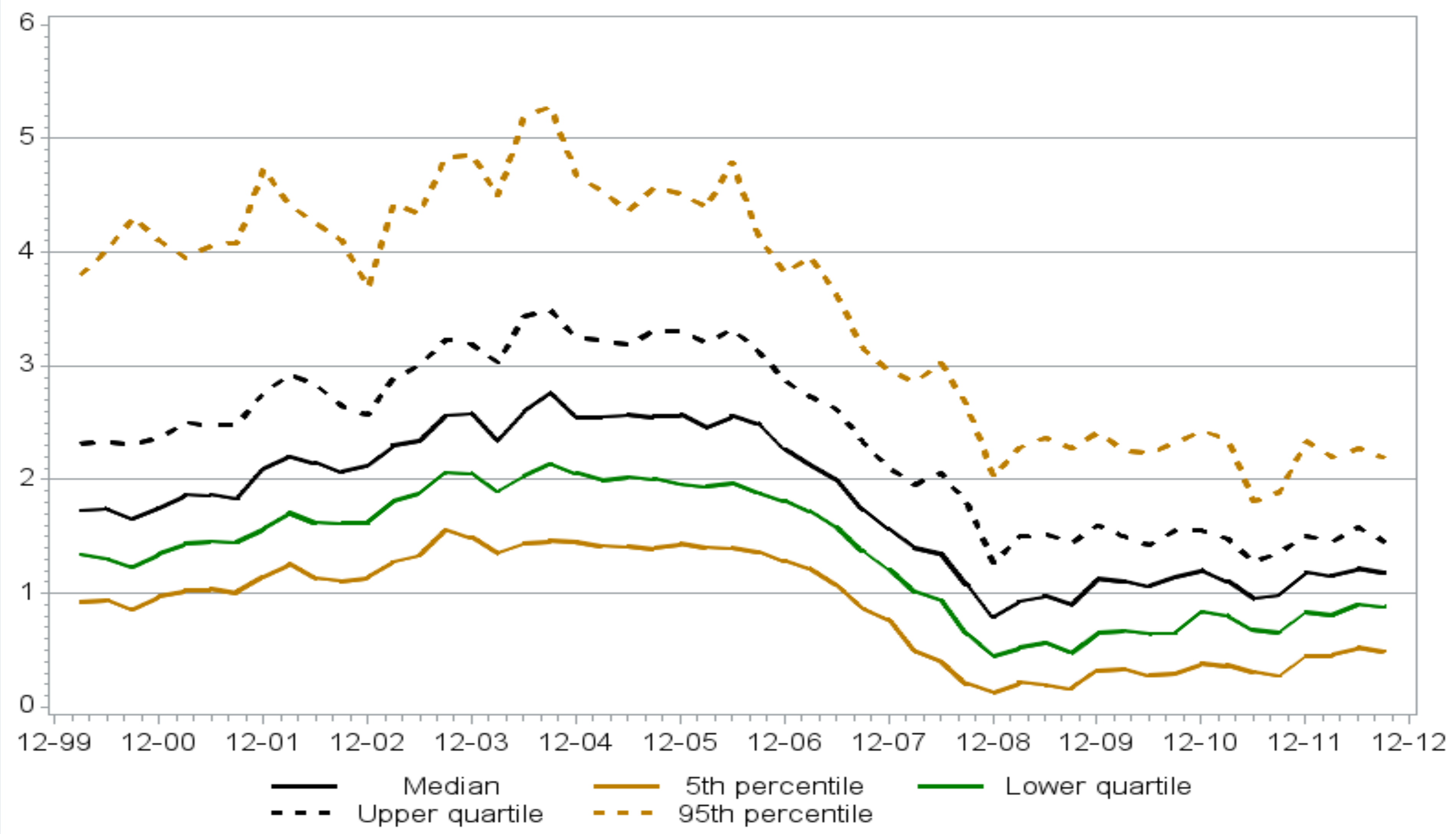
Source: Author's illustration.

Figure 5 **Ratio of the Market Cap to the Quasi–Market Value of Assets for European Banks That Required Substantial Government Intervention, April 2006–April 2010**



Source: Author's computation based on data from Datastream.

Overcoming Book Value Fetishism



Market-to-book ratios, large banks (June 2017)

US Bancorp	2.11
TD	1.73
M&T Bank	1.67
Wells Fargo	1.51
BONY Mellon	1.43
PNC Bank	1.43
JPM Chase	1.34
BB&T Bank	1.33
Morgan Stanley	1.20
Goldman Sachs	1.20
Bank of America	0.98
Citigroup	0.85
Capital One	0.80

Macroprudential regulation

- Creation of FSOC and OFR to identify risks and deal with them before they become a systemic problem.
- What about real estate? It is too politically sensitive to touch. But real estate is the primary threat to systemic problems, in the US and elsewhere. It has been the source of more than ¾ of banking crises in recent decades.
- FSOC is also partisan by construction (in that respect, a strange outlier in US regulatory history). Piwowar's complaints. And FSOC has unlimited powers to regulate or shut down any business in the US.
- In response to its decision about MetLife, a judge found that it abused its authority by failing to establish procedures for identifying systemic risks that warrant regulation, citing "fundamental violations of administrative law."
- One systemic risk action so far: limit on leveraged lending. Kim et al. (2017) find that it failed to achieve its goal (to limit system-wide leveraged lending) because unregulated banks increased leveraged loans one-for-one as regulated banks reduced them.

Liquidity regulation

- Basel liquidity standards are based on implicit view that liquidity risk is uncorrelated with default risk. In fact, history tells us the opposite: liquidity risk is a reflection of increases in default risk.
- Also, if liquidity risk were uncorrelated with default risk, then why not let a LOLR manage this "exogenous" liquidity risk, since there would be no moral hazard?
- Strangely, in the US, we limited LOLR authority in Dodd-Frank, and adopted Basel liquidity regulation.
- Is there a theory of liquidity regulation consistent with actual link to default risk? Calomiris, Heider and Hoerova (2017) develop such a theory, and show that cash reserve ratios can accomplish prudential risk management outcomes in combination with capital that capital alone cannot accomplish as well. Cash deposits in the central bank are observable and not risk-shiftable.
- Need to integrate proper LOLR reforms with simple remunerative central bank reserves/debt requirements, which requires revisiting of both liquidity regulation and Dodd-Frank limits on LOLR.

Orderly liquidation and living wills

- Bernanke argued that he and other regulators lacked ability to liquidate Bear Stearns and other nonbanks during the crisis, and that this created the bailouts. Title II of Dodd-Frank is supposed to end bailouts by making it possible for FDIC to liquidate nonbanks. Will this work?
- No. FDIC lacks experience, and probably legal authorities, to do what would be necessary to liquidate nonbank affiliates of bank holding companies, or to transfer capital from them to bank affiliates (Kupiec and Wallison 2015, Bliss and Edwards 2016).
- Furthermore, TLAC will often prove insufficient, which means liquidation is not feasible without large losses to uninsured claimants, which makes liquidation politically unlikely. Title II institutionalizes bailout procedures in that case.
- Bailouts are also likely the path of least resistance to preserve value (for FDIC's financial stake, and for economic reasons), given likely delays of liquidation (complex international jurisdictional issues) and human capital flight.

The Volcker Rule

- No connection to crisis causation. Securitizing mortgages is not outlawed by Volcker Rule, but proprietary trading in corporate debt markets is disallowed (but not speculation in US treasuries). This was an opportunity for Volcker to implement longstanding prejudices about the right way to structure the banking system (even he did not claim a causal story for the crisis).

- Large BHCs are obvious parties to do market making for OTC debt markets (global reach, client base). Banking studies tend to find evidence of gains from diversification of activities in large BHCs (securities underwriting and trading). There are also human capital synergies between market making and prop trading. Major costs of compliance to distinguish market making from proprietary trading.

Consumer protections?

- CARD Act places limits on risk pricing. Caused migration of risky credit card borrowers to shadow consumer credit providers (Elliehausen and Hannon (2017).
- Durbin Amendment limit on exchange fees for some banks on debit cards. Offset dollar-for-dollar by other fees (Kay et al. 2017).
- Operation Choke Point limits on bank services to politically disfavored industries, using excuse of bank "reputation risk" in serving those industries. Prejudices regarding Payday Lenders, in particular, destroyed that industry (Calomiris 2017). Shows abuses of combination of "guidance" and required secrecy in financial regulation.
- CFPB: unprecedented (and probably unconstitutional) authority and budget structure, currently under legal challenge. New "disparate impact" theory of discrimination, uses of forecasted race identity, other attempts to exceed legislative authority or precedents (auto loans).

Fed’s new roles, and new conflicts of interest

- Massive MBS holdings of Fed (1/6 of mortgage market). As the setter of interest rates, it stands to lose a lot if rates rise quickly.
- Fed’s new reliance on reverse repo (now competes with private parties that it regulates), and simultaneously established SLR, which increased costs for those competitors.
- Fed does care about its costs of operation, which matter politically a great deal, contrary to what economists argue it should care about.

Table 1. Ten Principles to Guide Financial Regulatory Reform

1. Financial regulation should focus exclusively on bona fide objectives that relate to the performance of the financial sector, grounded in core economic concepts of externalities and information costs and supported by evidence that shows that the costs of regulation are justified by demonstrable benefits.
2. We must restore the role of laws and formal rule making in financial regulation and end the reliance on guidance, as well as the excessive delegation of discretionary authority to politicized actors, such as the FSOC and the CFPB.
3. Regulatory standards and their enforcement must be transparent, so that regulators are accountable to the public.
4. To be effective, regulation must recognize and address the incentives of market participants to avoid regulatory costs and the incentives of supervisors and regulators to enforce (or not enforce) regulation.
5. Consumer protection regulation should help consumers make informed choices, not attempt to dictate those choices with prohibitive rules.

6. Financial institutions should pay for the losses that result from the risks they take, and so long as they are clearly and fully bearing the risks of their actions, regulation should avoid micromanaging the business of banking.

7. Real estate risk, especially when subsidized and promoted by the government, is a major threat to financial-system stability. Moreover, the subsidization of housing-finance risk is not an effective means of promoting access to affordable housing.

8. Conflicts of interest within regulatory agencies, especially the Fed, must be addressed.

9. Statutes and regulations governing the management of financial institutions that suffer financial distress need to be judged on the basis of politically and economically realistic scenarios for how those statutes and regulations will be used—not wishful thinking.

10. Designing financial regulatory policy should *not* be viewed as striking a balance between economic growth and financial stability. The best ideas for regulatory reform can achieve the highest sustainable growth without increasing the risk of a financial crisis.

Table 2. List of Proposed Reforms

1. Repeal the Durbin Amendment.
2. Repeal the risk-management and pricing limits of the CARD Act.
3. End Operation Choke Point.
4. Repeal the Volcker Rule.
5. Phase out use of guidance in financial regulation, and replace it with formal rule making.

6. Replace Title II resolution with a new bankruptcy chapter, following Jackson et al. (2015).
7. Replace the morass of capital ratio requirements on banks with a single 10% minimum tangible book equity-to-assets ratio and a single 15% minimum ratio of book equity to risk-based assets. For SIFIs, additionally require 10% of assets to be issued in CoCos with a market conversion trigger to incentivize banks to maintain sufficient economic value of equity.
8. When constructing risk-weights for bank assets, measure loan risk with interest rates on loans, and measure securities risks using objectified NRSRO ratings subject to market discipline.

Don’t depend unrealistically on bankruptcy

Prudential regulation should focus on keeping large banks away from insolvency threshold, not expecting to be tough on them once they are insolvent.

I favor bankruptcy chapter because I think it will produce more liquidations and better adherence to rule of law, not because I think it will produce liquidations of very large, complex banks. The emphasis with respect to those banks must be robust capital and cash requirements that keep them away from insolvency.

Furthermore, because I recognize that bailouts cannot be credibly avoided for the largest banks, rules governing them, passed in advance, would be desirable (to avoid delays during crises, and to constrain bailouts somewhat). (Calomiris and Khan 2015, Calomiris et al. 2017)

Harnessing market info. to ensure adequate capital: Calomiris and Herring (2013) CoCos requirement

<u>Key point #1</u>: CoCos should not be used as "bail in" instruments close to insolvency; rather to keep banks far away from insolvency.

<u>Key point #2</u>: CoCos are not an alternative to book equity requirements, but as a *means of ensuring that higher book equity requirements are meaningful*.

<u>Key point #3</u>: CoCos will only work if they rely on *market triggers*, and those will only be helpful if they are set at *high ratios of market equity value relative to assets*.

<u>Key point #4</u>: These will work better than market equity requirements, which could be relaxed. CoCo conversion risk involves third parties.

Measuring loan and securities risks

Loan risk has been shown to be well captured by all-in spreads charged on loans. This is a market-based measure that will not be manipulated by lenders to reduce capital requirements.

Ratings debasement reflected buy-side interest in reducing regulatory costs of ratings. Objectifying ratings and creating strong incentives for NRSROs to target objectified ratings will prevent ratings standards debasement.

9. Replace the two complex Basel liquidity requirements with a simple 20% remunerative cash-reserve ratio.
10. Spell out clearly and credibly the rules that guide lender-of-last-resort lending, limiting it to systemic risks, as discussed in Calomiris et al. 2017.
11. Provide a limited carve-out from leverage and liquidity regulations for OTC market making.

12. Reform stress tests to make them ex post transparent to ensure Fed accountability.
13. Reform stress tests by eliminating control of dividends by regulators for banks that are in compliance with all capital regulations.
14. Reform stress-test forecasting of cash flows using line-of-business managerial accounting data, and delay the further use of stress tests as a regulatory tool until these realistic scenario forecasts can be constructed.

15. Replace mortgage risk subsidies with means-tested down-payment matching subsidies, and wind down the FHA, GSEs, and FHLBs.

16. Offer means-tested subsidies for mortgage interest-rate swaps to lock in long-term rates.
17. Create tax-favored housing savings accounts to further promote affordability of housing.
18. Phase in limits constraining banks to less than 25% of loans on commercial or residential real estate.

19. Remove the FSOC and the OFR from the Treasury Department and establish them as an independent "Sentinel" to identify problems, monitor regulatory enforcement, and propose rules.

20. SIFI designations should be determined by clear rules, not opaque discretion.

21. Restructure and depoliticize the CFPB by structuring it as a bipartisan commission with a focus on enforcing consumer protection laws and by ending Federal Reserve funding of the CFPB.

22. Consolidate regulatory structures and avoid regulatory conflicts, following the suggestions in the 2008 Treasury blueprint.

Seven overarching conclusions

- Regulation is not achieving its objectives, but it is imposing enormous costs and undermining rule of law.
- Regulatory principles are needed to define proper objectives and recognize practical constraints on effectiveness. The need for simplicity and transparency are a consequence of those constraints.
- The use of market information is essential in making prudential regulation simple, transparent, and effective.
- Prudential regulation should focus on credible capital and cash requirements that avoid large bank insolvencies.
- Restoring the role of formal rule making, rather than Kafkaesque guidance, is essential for reducing regulatory risk and promoting due process and adherence to rule of law.
- Housing access politics should be addressed directly, rather than indirectly and ineffectively with politicized regulation.
- Regulatory restructuring is needed to avoid the abuse of discretion (CFPB, FSOC) and avoid current conflicts of interest (Fed).