Financial Risk Is Declining

By John M. Berry

Dodd-Frank, while incomplete, is working. Now if only the European banks were fully recapitalized.

It's been nearly three and a half years since President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act that is supposed to protect the nation and the world from the financial excesses that caused the worse economic slump since the Great Depression. Unfortunately, many of the new rules and regulations the act mandates have yet to be finalized and some aren't even in the draft stage. Nonetheless, however, some key provisions that are in force have sharply reduced the danger of any new crisis.

Leading the list are rules put in place last summer that require banks to hold far more capital than the relatively scanty amounts that left them and the financial system itself vulnerable to the crisis. Now almost all large institutions have substantially more capital than the new minimums available to absorb losses and avoid the need for taxpayer-financed bailouts. Those rules are now backed up by much closer supervision of major institutions that includes serious annual stress tests and the power to restrict dividend and other capital distributions if the level of capital is inadequate.

More important, perhaps, is the state of the world economy. At an International Monetary Fund economic research conference in early November, Lawrence H. Summers of Harvard University observed that another financial crisis "will surely come sometime and some place." But the recent one was partly

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Fully Engaged

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—J. Berry

Janet Yellen

the result of worldwide "complacency and euphoria" which is hardly the case today, he said. "I think those kinds of crises are a long way off."

Even if attitudes were to become far more upbeat, the new rules governing financial firms and the added oversight have made another crisis highly unlikely despite the missing pieces of Dodd-Frank. Furthermore, together the rules and added oversight have made another financial crisis highly unlikely even without all the other pieces of Dodd-Frank having been put in place. And some of those missing parts should show up soon. For instance, Treasury Secretary Jacob Lew is pushing multiple financial regulators to wrap up by the end of the year their long-running debate over the so-called Volcker Rule to restrict proprietary trading. And a few weeks ago the Federal Reserve Board put out for comment a proposal to institute a new liquidity coverage ratio, or LCR, so firms would be less likely to run out of cash if short-term funding were to dry up for some reason. Supervisors at major banks are already monitoring liquidity at those institutions on a daily basis, according to Fed staff.

"Since financial crises usually begin with a liquidity squeeze that weakens the capital position of vulnerable firms, it is essential that we adopt liquidity regulations to complement the stronger capital requirements, stress testing, and other enhancements to the regulatory system we have been putting in place over the past several years," said Federal Reserve Governor Daniel K. Tarullo, chairman of the Fed Board's Committee on Bank Supervision.

At an open Fed Board meeting on October 24, when the LCR proposal was put out for comment, Fed Vice Chair Janet L. Yellen, whom Obama has nominated to succeed Ben S. Bernanke as Fed chairman when his term expires at the end of January, showed her interest in the rule by closely questioning Fed staff members who drafted the proposal. Might it lead some banks to hoard liquid assets in a squeeze? Yellen asked. How would supervisors respond if a bank's liquidity temporarily fell below the required minimum? Could a bank count its access to loans at the Fed's discount window as part of its liquidity?

In other words, Yellen is fully engaged in the Dodd-Frank rulemaking process, as Bernanke has been. At an international monetary conference in China last summer, Yellen said that "tougher prudential regulation and supervision have substantially reduced the probability of a SIFI [systemically important financial institution] failure.

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Ending too-big-to-fail will require steadfast implementation by global regulators over the next few years of work already in train." For one thing, that may require capital surcharges to force the SIFIs to internalize the social costs of a potential failure, she said.

In July, the Fed issued a final rule that all supervised financial institutions must have a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5 percent and an additional "capital conservation buffer" of 2.5 percent of risk-weighted assets. The Basel Committee on Banking Supervision, an international coordinating group, is expected soon to propose a surcharge for SIFIs, such as mentioned by Yellen, of an additional 1 to 2.5 percentage points depending on how large the institution is. The Board is likely to implement such a surcharge for U.S. institutions shortly thereafter.

Beyond that, Yellen and Tarullo have suggested another requirement for the largest institutions: that they have enough unsecured long-term debt outstanding that in the event of a failure, the combination of capital and that debt would cover all the losses so the institution could be "resolved"—in essence shut down—without triggering a domino effect that could threaten other institutions or the financial system itself.

As Dodd-Frank has slowly been fleshed out, the country's gradual economic recovery, weak as it has been, has significantly reduced the overall level of stress in the banking industry. So far this year, only twenty-three relatively small banks in a dozen states have failed. That's down from fifty-one last year and 157 in 2010. The twenty-three banks had a total of only about $6 billion in assets, and the losses are expected to be collectively small enough that officials at the Federal Deposit Insurance Corporation say the balance in the Bank Insurance Fund, which covers most depositors, will continue steadily to increase.

The recovery has also benefited the largest institutions as well. Over the past four and a half years, the stress tests of the eighteen large bank holding companies participating in the Fed's Comprehensive Capital Analysis and Review have produced reassuring results. Collectively, their Tier 1 common equity capital has grown to $836 billion from $392 billion at the beginning of 2009. At mid-year, the ratio of that capital to risk-weighted assets was 11.1 percent, more than double the 5.3 percent at the beginning of the period, the Fed announced on November 1.

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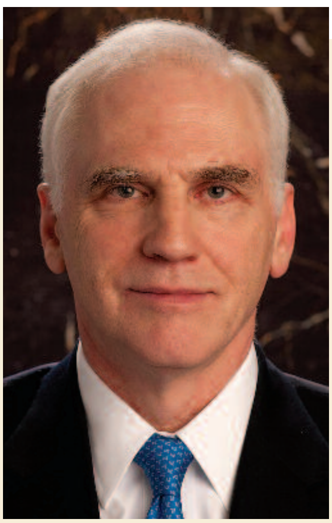
Last fall, the most severe hypothetical nine-quarter economic scenario used in the stress tests was severe indeed. It included a deep recession with U.S. unemployment reaching 12.1 percent, equity prices falling more than 50 percent, a 20 percent decline in housing prices, and a sharp market shock for the largest trading firms. All eighteen firms survived though they projected losses of $462 billion over the period of the scenario.

This year's test, which is just beginning, includes another dozen holding companies such as M&T Bank and Northern Trust. In addition, eight with substantial trading or custodial operations will have to include a counterparty default scenario. The new severely adverse scenario includes a world-wide slump, with U.S. GDP falling by nearly 5 percent and GDP falling by almost 6 percent in the eurozone with smaller drops in Britain and Japan. Growth slows sharply in most emerging market countries and China. Spreads on corporate bond rates to Treasuries widen by about 200 basis points. House and commercial real estate prices fall dramatically.

Most of the results of this latest round of tests will again be released company by company. All this provides a great deal of information to both supervisors and bank management about the health and relative riskiness of the firms' operations and the adequacy of their capital. Presumably managers at all the firms are also becoming better informed about the state of their counterparties and presumably have more confidence in them if some adverse event occurs.

As much as all these new rules and more sweeping supervisory activities have



Bank Regulatory Czar

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Dan Tarullo, *Chairman of the Federal Reserve's Committee on Bank Supervision* reduced the likelihood of a new crisis, there are some sources of risk they do not address. As Yellen put it in her China speech, “Important as banking reforms may be, it is worth recalling that the trigger for the acute phase of the financial crisis was the rapid unwinding of large amounts of short-term wholesale funding that had been made available to highly leveraged and/or maturity-transforming financial firms that were not subject to consolidated prudential supervision.”

“I believe the path forward is reasonably clear,” she continued. “We need to increase the transparency of shadow banking markets so that authorities can monitor for signs of excessive leverage and unstable maturity transformation outside regulated banks. We also need to take further steps to reduce the risk of runs on money market mutual funds. In addition, we need to further ameliorate risks in the settlement process for tri-party repo agreements.”

One step toward dealing with the wholesale short-term funding issue is a planned expansion of the proposed liquidity coverage ratio, which is focused on a thirty-day period in which all of a firm’s inflows and outflows of cash are compared. Under consideration is what is called a net stable funding ratio, or NSFR.

“Because the LCR creates only a thirty-day liquidity requirement and because liquidity strains can last considerably longer, the NSFR’s one-year structural funding requirement will be an essential complementary measure,” Tarullo said. The Basel Committee is close to completing work on such a measure, and when it does, he anticipates the Fed will propose a U.S. rule consistent with that proposal, he said.

Even when all the Dodd-Frank rules have been written and financial firms and their supervisors become fully experienced in their application, the probability of another financial crisis will never fall to zero. Take the stress tests, for example. The hypothetical scenarios seem to include everything but having the kitchen sink spring a leak in the list of things that could go wrong. But that doesn’t mean

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that something that no one has ever thought of can’t happen. Or perhaps as the Dodd-Frank rules bite ever more tightly, there will be a significant migration of financial activity outward to some relatively unregulated venue—regulatory arbitrage, if you will. Maybe the courts or Congress will undo some essential piece of what the law now calls for. And maybe there again will be a run on a money market fund breaking a buck, or the rules concerning the sale and use of derivatives will prove to be not nearly strict enough.

But is it likely that any of those things alone or in combination could do the damage to the financial system that occurred in 2007 and 2008 when so many institutions have beefed up their capital and so many supervisors with much better tools are watching so much more closely?

Adoption of all the rules has been a slow process. For one thing, the agencies are dealing with complex interconnections among various parts of the financial system and drafting rules is no easy matter. Yes, the Volcker Rule was simple as former Fed Chairman Paul Volcker proposed it. But proprietary trading turned out not to be so easily defined, and every time the Fed, the FDIC, the Comptroller of the Currency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission or someone else has proposed a rule, everyone possibly affected has had a right to comment on it—at length—and each agency has had to respond. Moreover, members of Congress have frequently put their oars in as well.

Still, the job is well on its way to getting done. The biggest unfinished piece of what is of necessity a global endeavor probably lies not in the United States, but in Europe, where many banks still are in serious need of recapitalization and the creation of a European Union-wide regulatory apparatus is still an uncertain goal. ◆