Is Banking Safer Today than before the Crisis?

T T RAM MOHAN

The world economy has been in slow motion for most of the period since the financial crisis of 2007. Interest rates fell steeply as central banks attempted to use monetary policy to get economies back on track. Falling interest rates result in lower interest margins for banks and a squeeze on profits. Banks have ended up paying hefty fines for assorted violations during and after the financial crisis.

This combination of adverse factors should have been bad news for banking in the advanced economies. It has been if you look at valuations of banks. Major banks in the United States (US) traded at below their book value until about a year or two ago. Leading banks in Europe are still trading below their book values. However, there is little talk of an imminent banking crisis. On the contrary, regulators exude confidence that banks have become safer, thanks to tighter regulation since the crisis. Is this true? The *Economist* (2017) devotes a special report to the subject and comes up with a tentative "yes." Many will be sceptical about this conclusion.

Regulators have taken several measures since the financial crisis of 2007 in order to ensure greater stability in banking. Three of these are seen as especially crucial. The Bank for International Settlements (BIS) has stipulated higher capital requirements. Regulators in the US and Europe have sought to bolster with "stress tests" that will check that banks have adequate capital under simulated conditions. In the US, regulators have stipulated "living wills" that will spell out how banks can meet their liabilities in the event of failure without requiring the injection of taxpayer money. In the US and the United Kingdom (UK), restrictions have been placed on the scope of banks.

Many, especially in the banking community, believe that the combination of higher capital and living wills suffices to make a huge difference to stability in banking. How true is this contention? Let us examine each of the key measures in turn.

Higher Capital Requirements

Following the crisis, the BIS came up with Basel III requirements for capital. Of the basic requirement of 8% of capital against risk-weighted assets, the share of tier 1 capital (which is equity plus quasi-equity capital) has been increased from 4% to 6%. In addition, Basel III prescribes a capital conservation buffer of up to 2.5%, a countercyclical buffer of up to 2.5% and a capital charge on systemically important banks of 2.5%. Adding up the various charges, the largest banks would require as much as 15.5% of capital, which is virtually double the requirement prior to the crisis.

In addition, regulators in the US have asked banks to hold debt that would convert into equity in a crisis. Total loss absorbing capacity (TLAC) would include equity and contingent convertibles that convert into equity. Jamie Dimon, the chief executive officer (CEO) of JPMorgan Chase, America's biggest bank, seems to think that regulators have erred on the side of excess.

In a letter to shareholders in April 2017, Dimon contended that "banks have too much capital" and that "essentially, 'too big to fail' has been solved—taxpayers will not pay if a bank fails" (Dimon 2017). Dimon based his contention on stress tests conducted by the US Federal Reserve (or Fed) on the top 33 major banks. The tests estimated losses at each bank assuming it would be the worst bank in a crisis. Even in this worst-case scenario, losses added up to less than 10% of the banks' combined capital. Dimon wrote, "This definitively proves that there is excess capital in the system."

Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, has pointed out the fallacy in Dimon's contention (Kashkari 2017). Dimon bases his argument on the total capital available with banks, which is equity plus bonds. This assumes that, in a crisis, after equity holders have been wiped out by losses at a bank, regulators will get bondholders to bear losses.

But we know that this seldom happens. When bondholders at a bank are forced to take losses, bondholders at other banks take flight, at the very least, they will not roll over the bonds on maturity. The failure of any bank would thus result in contagion. The only capital that matters when it comes to absorbing losses at a bank, therefore, is equity capital.

Despite Basel III, there is not enough equity capital in the system at the moment. Under Basel III, the leverage ratio (the ratio of equity to assets) is 3%. For the top six banks in the US, the ratio today is 6.6%. Kashkari thinks the leverage ratio for the biggest banks needs to move up to around 15% (which would mean a debt to equity ratio of about 5.5:1). For this to happen, the biggest banks would need to have a capital to risk-weighted assets ratio of 23.5% (*Financial Times* 2016).

In their well-known book, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It* (2013), two academics, Anat Admati and Martin Hellwig, take the case for higher capital even further. The authors argue that the leverage ratio may need to be as high as 25% for banks to be truly stable. This means that the debt to equity ratio would have to come down from 33:1 today to 3:1. In terms of having adequate capital at banks, we have a really long way to go.

In the US, there is a proposal in Congress to offer banks an alternative to the complex regulations of Dodd-Frank Act: a leverage ratio of 10:1. Then, banks do not have to opt for Basel III and other norms. The *Economist* (2017) says that small banks may opt for this alternative but not the larger banks.

Living Wills

We have thus far lacked mechanisms for orderly resolution of banks in a crisis. That is why governments had to infuse capital into banks in order to prevent failure. Living wills are intended to provide for orderly resolution, that is, losses would be borne by equity and bondholders (and, perhaps, by depositors with deposits above the guaranteed limit). The Dodd-Frank Act in the US has provisions for living wills and it also creates a new resolution authority called the Orderly Liquidation Authority.

In 2014, 11 US banks submitted their living wills to the Federal Deposit Insurance Corporation (FDIC). All were rejected. In 2016, five out of eight living wills were rejected by the Fed and the FDIC. There are serious doubts as to whether living wills will ever work in practice.

The living wills are based on estimates of the value of assets and liabilities in normal times. In times of crises, the valuations may well turn out to be incorrect. Many of the large banks operate across several countries. Cross-border resolution of assets and liabilities poses formidable challenges.

Moreover, living wills hinge on TLAC, which includes convertible debt. The idea in having debt as a component of TLAC is that debt is cheaper than equity. But if investors believe that debt is likely to be converted into equity with a high probability, they are likely to price it closer to equity, thereby defeating the purpose of having a debt-like instrument. The concept of living wills as a means of making the banking system safer fails to inspire confidence.

Restrictions on Scope

There is a view that banks came to grief in the financial crisis because they were using depositor money for high-risk activities. In the US and the UK, regulators have moved to restrict the scope of banks' activities. In the US, we have the Volcker Rule in the Dodd-Frank Act. Under the rule, banks are barred from proprietary trading, hedge funds, and private equity.

The UK has opted to ring-fence retail banking activities from investment banking activities as recommended by the Vickers Commission. There will be higher capital requirements for the retail banking part and the regulatory safety net will be available for the retail part alone.

Do restrictions on scope make banking safer? First, there are significant challenges of implementation. In the US, it has been especially difficult to define "proprietary trading" under the Volcker Rule and to distinguish it from hedging or market-making activities. In the UK, ensuring that retail banking is properly ring-fenced poses its own challenges.

That apart, it is not clear that it is the integration of investment banking with retail banking that makes banking riskier. In the last crisis, some investment banks (for example, Bear Stearns and Lehman Brothers) failed as did some pure commercial banks (such as Northern Rock and Washington Mutual). Some banks that combined commercial and investment banking (for example, Royal Bank of Scotland) failed while others (for example, JPMorgan Chase) weathered the storm.

Moreover, separating investment banking from commercial banking would reverse a market-driven process stretching over a long period as banks found that they were losing clients to the capital markets. The problem for universal banks may not be scope of operations per se. It may be that they have not, in the past, set appropriate limits for various activities or income streams in accordance with prudent norms of risk management. The answer, then, is not to eliminate proprietary trading or hedge fund activities but to place appropriate limits on exposures to these activities.

If greater scope has resulted in banks becoming bigger, then, perhaps, the problem is better addressed by addressing the problem of size itself. As the argument goes, if a bank is too big to fail, it should be too big to exist in the first place. Simon Johnson of the Sloan School of Management, Massachusetts Institute of Technology, has argued that banks' size should be limited to 2% of gross domestic product. At least for now, the idea is too radical for regulators to stomach.

It does appear that banking stability is still some distance away. If we are to stick to conventional approaches to protecting stability, then our best bet is to require banks to have substantially more capital than is contemplated under Basel III. But this is an idea that has yet to gain general acceptance.

A paper that came out last year should jolt regulators out of their complacency (Sarin and Summers 2016). Using several measures of risk, the paper finds that banks in the US and elsewhere are not safe. If banks were safer, bank equity should be less volatile and there should be less market expectation of future volatility of equity. It turns out that this is not the case. Measures of volatility are higher post-crisis than before the crisis.

The authors find that the franchise value of most institutions, reflected in the ratio of market value of equity to assets, has declined significantly for most major institutions after the crisis. This naturally signals higher risk: there is less equity available to bear losses on assets. The authors say that their findings "clearly call into question the view of many officials and financial sector leaders who believe that large banks are far safer today than they were a decade ago." That is certainly something for regulators and policymakers to chew over.

T T Ram Mohan (*ttr@iima.ac.in*) teaches at the Indian Institute of Management, Ahmedabad.

REFERENCES

Dimon, Jamie (2017): "Dear Fellow Shareholders," 4 April, https://www. jpmorganchase.com/corporate/investor-relations/document/ar2016-ceolettershareholders.pdf.

Economist (2017): "A Decade After the Crisis, How Are the World's Banks Doing?" 6–12 May, http://www.economist.com/news/special-report/21721503-though-effects-financial-crisis-2007-08-are-still-reverberating-banks-are.

Financial Times (2016): "Neel Kashkari Pulls No Punches in Plan to End 'Too Big Too Fail'," 18 November, https://www.ft.com/content/b4b0a16a-ad4e-11e6-9cb3-bb8207902122.

Kashkari, Neel (2017): "Jamie Dimon's Shareholder (Advocacy) Letter," *Medium.com*, 6 April, https://medium.com/@neelkashkari/jamie-dimons-shareholder-advocacy-letter-c2d867f-3cc1e.

Sarin, Natasha and Lawrence H Summers (2016): "Have Big Banks Gotten Safer," *Brooking Papers on Economic Activity*, Fall, https://www. brookings.edu/bpea-articles/have-big-banks-gotten-safer/.