Basel III, Dodd-Frank, and Volcker Rule Unworkable

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Following are comments by John Brynjolfsson that were submitted to the CFS Policy Forum on Bank Capital and Liquidity Rules.

Recently Professor Hanke of John Hopkins University criticized Basel III, suggesting instead that capital of banks was adequate, and we needed to take the bridles off US and global banks to so that they could lend more and expand M3. Prominent in his editorial was an appeal to insights of banking experts Jamie Dimon and Joseph Ackerman.

While I would certainly consider Messrs. Dimon and Ackerman to be knowledgeable and informed, their comments are anything but disinterested. Professor Hanke, while presumably less conflicted, provides little analysis beyond referencing the bankers' comments and banking industry reports.

Of greater concern to me than credentials or associations, is that both the Basel III framework, and the Hanke/Dimon/Ackerman alternative seem to be built upon a foundation that a continuation of past mistakes should be perpetuated. In the past, we naively thought private profits within consumer deposit-taking institutions could be supported by socialized losses. These losses were associated with explicit and implicit guarantees covering huge risks taking in capital markets and merchant banking activities. This mistake could be understood, prior to 2008, as various observers naively had faith in regulators' ability to make subtle distinctions, or had faith in shareholders' and managements' omniscience and rationality, believing that they could simultaneously serve their personal ambitions and the public mission. Post-2008 it is difficult to image that anyone, much less those as sophisticated as Hanke, Dimon and Ackerman, could have such faith.

A roadmap for the future must eliminate significant private underwriting of risk within institutions that have the ability to socialize the losses. That means we must eliminate risk taking at institutions that are "too big to fail," and institutions that take retail deposits backed by FDIC insurance. In addition, we must reinforce political commitments to never again have bailouts, and create credible structural bright-line distinctions between entities that are publicly guaranteed, and those that are private, and therefore free to succeed and fail separate from the public purse. We also need to use anti-trust frameworks, or other government tools to preclude the creation of, or continued unfettered existence of, entities that are too big to fail or too big to bail.

We must realize that the national goal of being the domicile for the largest global banking franchise is a fool's errand. In particular, if the government and citizens of some other country are willing to foolishly subsidize a global bank domiciled in their home territory, both directly in terms of low capital requirements and indirectly in terms of socializing within their country future losses, we need not follow suit, or even envy them.

Another aspect of flawed thinking by Hanke, and ironically many on the left like Paul Krugman, is to start with the premise that more risk taking by retail deposit-taking institutions is a necessary and sufficient condition for getting out of our current cyclical and structural slump.

Rather a more logical framework for working through the deadwood created by the credit bubble and its implosion is to increase accountability of financial market, and economic, decision makers. Increased accountability is best done by building on the concept of transparency, private contracts, laws and courts. Though regulation still plays a role, it is well defined with a narrowly limited purview, and is enforced universally, rather than discretionarily. Such a framework would have a bright line distinction between retail deposits-taking and capital markets activities. It surely can involve a social aspect to banking, in terms of providing community service to youngsters or others whose balances are so small they are unable to cover the cost of their banking services, but would reject the crony capitalism, big business aspects of broad guarantees.

I, for one, now reject the idea that retail deposits provide a suitable foundation upon which to build a superstructure global risk capital allocation. The two concepts of money/deposits/transactional accounts and global risk underwriting are entirely distinct.

Retail and other deposits need to be riskless, not just low risk. Such accounts serve as a nexus for electronic contractual transactions, much as coin, paper money, or checks did a 1,000 years ago, 200 years ago, and 50 years ago, respectively.

In contrast, the superstructure for global risk capital allocation, of which I'm a big fan as it is ultimately the key to productivity growth, at its heart involves allocating the large losses and large returns. The transactional aspects of these activities are of tertiary importance. Capital market endeavors can obviously be highly lucrative, in turning large amounts of capital into huge amounts of capital; however they are anything but a license to print money. We all know, or should know, just as the profits to risk taking can be huge, the losses due to a roll of the dice, or due to a minor miscalculation, can be as large, or even larger!

Inherent in this is a "stack" of recovery priorities associated with global risk taking. It should look something like the following:

a. Retail and small deposits needed to serve the needs of small savers, and transactions. These deposit accounts need to be riskless. As such the assets backing them need to be near riskless, and the FDIC needs to guarantee them. It is in this context that there is a need to tightly regulate the assets backing those retail deposits, so as to avoid society underwriting losses associated with private profits. As such, it makes sense to completely ring-fence the retail deposit taking subsidiaries of financial institutions, if not the entire financial institution choosing to own a deposit taking subsidiary

b. A small sliver of equity risk capital must be associated with performing the operational and service functions associated with retail deposit taking. However, since there would be virtually no capital market risk taking, the need for such capital would be modest. For example, the FDIC could see to it that community banks could lease, rather than own, the real estate needed for retail bank branches or to house ATMs, to reduce risk associated with commercial real estate market fluctuations.

   Note: "interest" on small retail deposits will necessarily be low, or non-existent, while "transaction fees" may be seemingly high. This is reality. If it costs money to service a checking account, reality is the account holder will/should expect to cover those costs.

Separate from such "riskless" retail functions, there are a whole range of capital market activities and investing activities more generally. The recovery stack, in case of losses, for these activities, is separate from deposit taking institutions and looks something like:

c. Senior loans, senior bonds, secured bonds and commercial mortgages, either standardized sufficiently, or documented by sophisticated attorneys to have covenants, and a first claim on recovery assets;

d. Ordinary bonds, trade finance, general obligations to lenders, vendors, customers, employees, counterparties, and the like;

e. Junior or subordinated bonds, capital notes, preferred stock, and the like; and

f. Common equity.

Under such a framework, investors, rather than transact, can allocate capital inter-temporally, geographically, across investment opportunities, and states of nature. Such capital markets activities are "regulated" by the principals involved in investing their own capital.

Most importantly, there is no expectation that the public purse will be used to bail out private risk takers.