WRITTEN TESTIMONY OF
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BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"BANK CAPITAL AND LIQUIDITY REGULATION PART II:
INDUSTRY PERSPECTIVE"

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WITNESS BACKGROUND STATEMENT

Jennifer Taub is a Professor at Vermont Law School where she teaches courses in contracts, corporations, securities regulation, and white-collar crime. She earned a J.D. *cum laude* from Harvard Law School, and a B.A. *cum laude* from Yale College. Prior to joining academia, she was an associate general counsel at Fidelity Investments.

Professor Taub has researched and written extensively about the 2008 financial crisis. This includes the book, *Other People's Houses*, published in 2014 by Yale University Press, which includes a chapter dispelling the top ten myths about the financial crisis.

Professor Taub has not received any compensation in connection with her testimony, nor has she received federal grants or contracts. The views expressed in her testimony are her own and do not represent the positions of her law school or any other organization with which she is affiliated.

WITNESS TESTIMONY

Chairman Shelby, Ranking Member Brown, and distinguished members of this Committee, thank you for the opportunity to testify today. My name is Jennifer Taub. I am a professor at Vermont Law School. I offer my remarks today solely as an academic and not on behalf of any association.

The title of today's hearing, "Bank Capital and Liquidity Regulation" sounds terribly technical, seemingly a topic just for the experts. But it's not. Reducing excessive bank borrowing through higher capital requirements matters to us all.

Bank capital is much more than just numbers you can *count up* on a balance sheet. Bank capital is what we can *count on* to ensure a more stable financial system that serves the credit needs of American families and businesses. When banks borrow excessively — in good times they gain, in bad times, we *all* lose. If banks teeter and topple, lending tightens and the broader economy suffers. We see job losses, investment losses, and home losses. This is a hard lesson that we have learned — and *forgotten* — time and time again.

If we read and take financial historians seriously, we would understand that this time is not—and will not ever be—different. Financial crises share common elements. They typically result from the deflation of debt-fueled-asset bubbles. [1] After an asset bubble deflates, thinly capitalized banks that hold those assets collapse when depositors or other lenders withdraw their money. Even good assets cannot be sold at full price under stress. Government-backed rescues follow when leaders realize the collapse of a giant bank could cause cascading failures and more widespread damage.

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[1] *See*, Hyman Minsky, *Stabilizing and Unstable Economy* (Yale University Press, 1986); Martin H. Wolfon, *Financial Crises: Understanding the Postwar U.S. Experience* (M.E. Sharpe, 1994); Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009) ("No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experiences from other countries and from history"), Erik Gerding, *Laws, Bubbles, and Financial Regulation* (Routledge 2013), John Geanakoplos, "The Leverage Cycle 2," (Cowles Found. for Research in Econ., Discussion Paper No. 1715R, 2009), available at http://cowles.econ.yale.edu/ P/cd/d17a/d1715.pdf ("In the absence of intervention, leverage becomes too high in boom times and too low in bad times. As a result, in boom times asset prices are too high, and in crisis times they are too low. This is the leverage cycle."), Robert J. Shiller, *Irrational Exuberance* Revised and Expanded Third Edition (Princeton University Press, 2016).

We were schooled in this too-big-and-too-leveraged-and-too-interconnected-to-fail problem in 2008. Let's recall that the U.S. government committed many trillions of dollars in direct bailouts and indirect backstops to rescue the system. Some will seek to assure you that this doesn't matter anymore, because most of the money was paid back. That is cold comfort for the more than six million families who lost their homes to foreclosure since 2008 and to all of us who are still struggling in an economy that is just beginning to pick up steam.

Wall Street quickly went back to "business as usual,"[2] turned record profits, and paid out large dividends to shareholders. These dividends represent money that could have been retained to build up capital. Meanwhile Main Street is still slowly recovering. As memories of the painful post-crash years fade, hopefully the political courage to take decisive action to prevent another future crisis does not diminish.[3]

Bank profits are now at an all time high. According to FDIC Chairman Martin Gruenberg, "FDIC-insured institutions earned nearly $164 billion in 2015, a new record."[4] Moreover, only eight failed. The timing could not be better to focus now on implementing much higher bank capital requirements.

Bipartisan Consensus on Capital

There is considerable bipartisan consensus on capital. Just two weeks ago, on June 7th, when this Committee initially held a hearing on this subject matter, Chairman Shelby began by emphasizing the importance of strong capital requirements to promote a safe and sound banking system and to avoid taxpayer bailouts. Similarly, Ranking Member Brown recognized during his opening remarks:

> Experts on the left and on the right agree that capital is a vital element of financial stability. Capital lessens the likelihood that an institution will fail. It lowers the

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[2] Joris Luyendijk, "How the Banks Ignored the Lessons of the Crash—Joris Luyendijk spent two years talking to hundreds of City insiders. They revealed how close we came to disaster – and how quickly finance went back to business as usual," *The Guardian*, Sept. 30, 2015 ("Seven years after the collapse of Lehman Brothers, it is often said that nothing was learned from the crash. This is too optimistic. The big banks have surely drawn a lesson from the crash and its aftermath: that in the end there is very little they will not get away with.")

[3] See Jennifer Taub, *Other People's Houses: How Decades of Bailouts, Captive Regulators, and Toxic Bankers Made Home Mortgages a Thrilling Business*, Paperback edition, (Yale University Press, 2015), p. xi.

[4] Martin J. Gruenberg, "The Impact of Post-Crisis Reforms on the U.S. Financial System and Economy," Speech to the Exchequer Club, Washington, D.C., June 15, 2016.

> cost to the financial system, and most importantly to the economy if it does. Requiring the largest banks to fund themselves with more equity will provide them with a simple choice: they can either 'fully internalize the risk' that they pose to the economy . . . or they can become smaller and simpler.[5]

With this level of agreement across the political spectrum, what then are the points of contention and indecision that make this a worthy subject for deliberation instead of bold action?

The ongoing debate seems to surround the following points (1) what do we mean by capital; (2) how much capital should be required, (3) are the arguments against higher capital valid, and (4) is capital a sufficient substitute for other regulations including related to liquidity?

What Do We Mean by Capital?

There are considerable differences in what we talk about when we talk about capital. I like to refer to capital as the non-risk-weighted equity capital ratio, what some call a "leverage" ratio. This calculation is an assets-to-equity measurement. Ideally, this would include certain off-balance-sheet items as assets. Sometimes when others talk about capital they might mean a risk-weighted measure of equity capital. This method treats asset types differently, reducing the amount of equity needed to fund them based on their perceived riskiness.

While a leverage ratio is a blunt instrument, it is simple and transparent, less subject to manipulation than a risk-weighted capital ratio can be.[6] While the risk-weighted- approach can complement the leverage ratio, it is not enough on its own. It has been subject to arbitrage and abuse.[7]

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[5] United States Senate Committee on Banking, Housing, and Urban Affairs, "Bank Capital and Liquidity Regulation (June 7, 2016) available at http://www.banking.senate.gov/public/index.cfm/hearings?ID=E4DB4F1F-2053-4E72-BEB9-2B47B3A04676

[6] See Anat R. Admati, "Where's the Courage to Act on Banks," *BloombergView,* October 12, 2015, available at https://www.bloomberg.com/view/articles/2015-10-12/where-s-the-courage-to-act-on-banks-
"Regulators focus on 'risk-weighted' and accounting-based capital ratios that, among their many flaws, rely on banks to assess the riskiness of their assets. Using off-balance-sheet accounting, derivatives and other tools, banks have become adept at manipulating these ratios."

[7] For example, before the crisis, in addition to a minimum leverage ratio, banks were subject to capital standards which imposed a minimum of 8 percent capital to risk-weighted assets. An asset with a 0 percent risk weighting would need no capital backing, and one with a 100 percent risk

To explain an equity capital leverage ratio, the following illustration might be helpful. Imagine that I wish to buy a small business for $100,000. I borrow $95,000 from my cousin and I pay the remaining balance to the previous owner in cash. After that transaction, my equity capital would be $5,000, the difference between what I own and what I owe. That's a 5% leverage ratio. Or stated different a 20-to-1 assets-to-equity leverage ratio.

If my cousin suddenly demands the money back, hopefully I can sell the business for at least the $95,000 I owe. If not, I've wiped out my capital and would be scrambling for other things to sell to fully pay back that loan. That's the downside of leverage.

However, if I can sell the business for $105,000, I've doubled my money, or in other words, achieved a 100 percent return on equity. This is the upside of leverage — the ability to transform a 5% increase in asset value to a 100% return on ones investment. Extending this metaphor, liquidity is about whether I have enough cash to fully pay back the loan to my cousin while I wait a bit to try to fetch a better price for that business.

Similarly, banks borrow money from their depositors and other lenders. They use this funding to make loans and buy other assets including derivatives. If their depositors or other lenders to the bank demand their money back and assets can't be sold at full value, the bank's capital cushion is supposed to absorb the difference. If it is too thin, upon insolvency, a bank may be shuttered and sold, or we the people may have to bail it out.

How Much Capital Should be Required?

The Dodd-Frank Act provides regulators with the tools to rein-in excessive borrowing as well as to take other steps to help prevent financial crises of the magnitude we experienced in 2008. Section 171 sets a generally applicable leverage ratio, and Section 165 requires the Fed to make rules for enhanced prudential standards, including

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weighting would need an 8 percent backing, meaning borrowing $92 to finance every $100 of such assets. Whereas mortgage bonds had been give a 50 percent risk weighting, after November 2001, they were given a 20 percent risk weighting. So, instead of being required to have 4 percent capital, they needed only 1.6 percent. In other words, they could borrow $98.4 million to purchase $100 million in private-label MBS if they had triple-A or double-A ratings. Meanwhile a whole mortgage loan still had a 50 percent risk weighing. *See Other People's Houses*, p. 232.

reduced leverage for the largest financial firms. The final rules have made the system safer, but not safe enough.

The current minimum 4 percent equity capital leverage ratio is too low. The future leverage ratios of 5 percent for our largest bank holding companies and 6 percent for their insured depositories, which have not yet gone into effect, will still be too low.

I concur with Professor Heidi Schooner who testified before this Committee at the June 7th hearing that "[w]hile adequate capitalization is central to the safe operations of financial institutions, little justifies the current low levels of capital required under banking rules."[8]

Anat Admati and Martin Hellwig recommend at least a 20 percent non-risk-weighted equity capital ratio, including in their book *The Bankers' New Clothes*.[9] In a letter to the *Financial Times*, together with other leading economists they argued for "at least 15%, of banks' total, non-risk-weighted assets [be] funded by equity."[10]

Others would go even higher. During a 2010 CNBC interview, Nobel Laureate Eugene Fama (who also signed the *FT* letter) said: "the only solution I see is to raise capital requirements on these firms dramatically. . . Maybe they have to go up to 40 or 50 percent so that this whole idea of these big firms failing is just taken right off the table. Let the stockholders bear the ups and the downs without having to pass it on to the taxpayers."[11]

Arguments Against Higher Capital

Opponents of higher capital requirements contend that it would be too costly. In their comprehensive paper, entitled, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive," Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer convincingly address many

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[8]Heidi Mandanis Schooner, "Top-Down Bank Capital Regulation," 55 *Washburn Law Journal* 327 (2016) (In her recent article, "Top-Down Capital Regulation," Professor Schooner argues for a system in which "capital ratios applicable to all banks would be set high—high enough so that the risk of undercapitalization is very small. The opposite risk, the risk associated with requiring excessive capital, would be addressed through a supervisory process, in which banks could be permitted, on a firm-by-firm basis, to operate below capital levels set by rule.")

[9] Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* Paperback (Princeton University Press, 2014), pp 176 - 187.

[10] Admati, et. al, "Healthy Banking System if the Goal, Not Profitable Banks," *Financial Times*, Nov. 9, 2010.

[11] "Father of Modern Finance Weighs In," *CNBC Squawk Box*, May 27, 2010.

of the arguments that are advanced in opposition to higher capital requirements. They challenge the contention that more equity funding for banks would restrict lending and would otherwise be costly to society. [12] They assert that greater equity would result in less distorted incentives and thus better lending decisions, for example. They conclude "that the social costs of significantly increasing equity requirements for large financial institutions would be, if there were any at all, very small."

In another persuasive article, Admati observes that: "Nothing about the business of banking makes it essential or beneficial for banks to operate with the very low equity levels they choose to maintain."[13] While most banks have at most a 6 percent equity capital cushion, by comparison, ordinary operating companies rarely have less than 30 percent.

Higher Equity Capital is Not a Free Pass

A healthy equity capital cushion is necessary but not sufficient. Moreover, allowing banks with a mere 10 percent leverage ratio a free pass from other crisis prevention and intervention rules is misguided. This is but one of the many faults with a bill that House Financial Service Committee Chairman Hensarling is introducing.

As but one example, liquidity also matters. In testimony before the Financial Crisis Inquiry Commission in 2010, Goldman Sachs CEO Lloyd Blankfein noted:

> Certainly, enhanced capital requirements in general will reduce systemic risk. But we should not overlook liquidity. If a significant portion of an institution's assets

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[12] See Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive," October 22, 2013 ("A pervasive view that underlies most discussions of capital regulation is that 'equity is expensive,' and that equity requirements, while offering substantial benefits in preventing crises, also impose costs on the financial system and possibly on the economy. Bankers have mounted a campaign against increasing equity requirements. Policymakers and regulators are particularly concerned by assertions that increased equity requirements would restrict bank lending and impede economic growth. . . We consider this very troubling, because, as we show below, the view that equity is expensive is flawed in the context of capital regulation. From society's perspective, in fact, having a fragile financial system in which banks and other financial institutions are funded with too little equity is inefficient and indeed 'expensive.'") available at https://www.gsb.stanford.edu/sites/default/files/research/documents/Fallacies%20Nov%201.pdf

[13] Anat R. Admati, "The Missed Opportunity and Challenge of Capital Regulation," Dec. 2015, available at http://financial-stability.org/wp-content/uploads/2016/03/2015-12_admati_challenge-of-capital-regulation.pdf

are impaired and illiquid and its funding is relying on short-term borrowing, low leverage will not be much comfort.[14]

Banks are still overly-dependent on short-term wholesale funding.[15] The collapses of both Bear Stearns and Lehman Brothers were precipitated by a “run on repo”—when the institutions that had extended short-term and overnight credit to the investment banks withdrew their financing. The continued reliance on this short-term, wholesale funding creates what Fed Governor Dan Tarullo and others call “fire sale” risk. While some of this risk might be mitigated by the Liquidity Coverage Ration rules, presently this is still a large market with more than $1.5 trillion in tri-party repo alone.[16]

As Fed Vice Chairman Tom Hoenig noted in April, the eight U.S. global systemically important banking institutions (G-SIBs) "continue to rely on wholesale funding, deposit-like money market funds, and repos, all of which are major sources of volatility in uncertain times."[17]

Conclusion

At the June 7th hearing, Chairman Shelby recalled that in 2006, he warned of the danger of thinly-capitalized banks and "how a crisis in the banking system quickly infects

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[14] Testimony of Lloyd Blankfein, The Official Transcript of the First Public Hearing of the Financial Crisis Inquiry Commission Hearing, January 13, 2010, p. 9.

[15] See, e.g., Daniel K. Tarullo, Member of the Bd. of Governors of the Fed. Reserve Sys., speech at the Americans for Financial Reform and Economic Policy Institute Conference, Shadow Banking and Systemic Risk Regulation (Nov. 22, 2013); Liz Capo McCormick, "New York Fed Says Repo Fire Sale Risks Not Being Addressed," *Bloomberg* (Feb. 13, 2014), http://www.bloomberg.com/news/2014-02-13/new-york-fed-says-repo-fire-sales-risks-are-not-being-addressed.html; Jennifer Taub, "Time to Reduce Repo Run Risk," *New York Times DealBook* (Apr. 4, 2014), http://dealbook.nytimes.com/2014/04/04/time-to-reduce-repo-run-risk/; Ryan Tracy, "Fed Officials Suggest Limiting Banks’ Repo Exposure: Rosengren and Dudley Say Large Markets for Repurchase Agreements Could Cause Instability Again," *Wall Street Journal* (Aug. 13, 2014), http://online.wsj.com/articles/fedofficial-suggests-limiting-banks-repo-exposure-1407936002. According to a report on “Contagion,” reliance on short-term, wholesale funding means a bank is “more likely to suffer distress” and “the best predictor of a bank’s contribution to systemic risk.” *Committee on Capital Markets Regulation, What to Do about Contagion?* 34–35 (Sept. 3, 2014), available at http:// capmktsreg.org/app/uploads/2014/09/2014-09-03-WDAC.pdf

[16] Federal Reserve Bank of New York Tri-Party Repo Statistics as of 04/11/2016 available at https://www.newyorkfed.org/medialibrary/media/banking/pdf/apr16_tpr_stats.pdf?la=en

[17] Thomas M. Hoenig, FDIC Board Meeting Statement of Vice Chairman Thomas M. Hoenig regarding 2015 Title I plans submitted by the eight domestic GSIBs, April 13, 2016, available at https://www.fdic.gov/news/news/speeches/spapr1316a.html

the rest of our economy." He also noted that with the 2008 financial crisis, it became apparent that "the amount of high-quality capital" at banks "was "insufficient." He asked whether banks today could withstand another financial crisis. Unfortunately, the answer to that question is no. Our top banks are larger than they were before the crisis, are permitted to borrow excessively relative to the assets they hold, are too opaque to regulators and their own executives, and remain overly dependent on short-term wholesale funding.[18]

Raising the minimum equity capital requirements dramatically could substantially improve the likelihood that individual bank failures would be self-contained. However, increased equity capital, alone, especially at the levels this Congress or the regulators are likely to implement, would not justify rolling back other protections.

In conclusion, more bank equity capital and better bank liquidity means less systemic risk and reduces the cost of crises. Increased equity capital makes banks less fragile and more capable of lending even after suffering losses. With banks reporting record profits, it's time now to act where there is consensus and substantially raise bank equity capital requirements.

Thank you for this opportunity to speak. I look forward to your questions.

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[18] Frank Partnoy & Jesse Eisinger, "What's Inside America's Banks?," *The Atlantic* (Jan. 2, 2013), http://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/; Peter Eavis, "Regulators Size up Wall Street, With Worry," *New York Times*, (Mar. 12, 2014), http://dealbook.nytimes.com/2014/03/12/questions-are-asked-of-rot-in-banking-culture/; William Dudley, President of the Federal Reserve Bank of New York, said in 2013, "There is evidence of deep-seated cultural and ethical failures at many large financial institutions;" and in a 2014 interview he said, "Either the firm is not too complex, you can manage it, you do know what's going on. Or, if you don't know, that's sort of raising the question whether the firm is too complex to manage.").