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To the Committee on Financial Services
U.S. House of Representatives

Hearing on 'Making a Financial Choice: More Capital or More Government Control?'

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An Excellent Choice

Mr. Chairman, Ranking Member Waters and members of the committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I spent 35 years in banking, including 12 years as president and CEO of the Federal Home Loan Bank of Chicago and then 11 years as a fellow of the American Enterprise Institute, before joining R Street earlier this year. I have both experienced and studied many financial cycles, including the political contributions and reactions to them, and my work includes the issues of banking systems, central banking, risk and uncertainty in finance, housing finance and government-sponsored enterprises and the study of financial history.

"Detailed intrusive regulation is doomed to fail." This is the considered and, in my view, correct conclusion of a prominent expert in bank regulation, Sir Howard Davies, former chairman of the U.K. Financial Services Authority and former director of the London School of Economics. Detailed, intrusive regulation is what we've got, and under the Dodd-Frank Act, ever more of it. "Financial markets cannot be directly 'controlled' by public authorities except at unsustainable cost," Davies adds. Surely there is a better way to proceed than promoting unfettered bureaucratic agencies trying through onerous regulation to do something at which they are doomed to fail.

I believe the CHOICE Act offers the opportunity of a better way, precisely by offering banks a fundamental choice.

The lack of sufficient capital in banks is a permanent and irresistible temptation to governments to pursue intrusive microregulation, which becomes micromanagement. This has an underlying logic to it. In a world in which governments explicitly and implicitly guarantee bank creditors, the government in effect is supplying risk capital to the banks which do not have enough of their own. Suppose the real requirement in a true market would be for an equity capital ratio of 8 percent of assets, but the bank

has only 4 percent. The government implicitly provides the other 4 percent – or half the required capital. We should not be surprised when the, in effect, 50 percent shareholder demands a significant say about how the bank is run, even if the resulting detailed regulations will not be successful.

However, the greater the equity capital is, the less rationale there is for the detailed regulation. In our example, if the bank's own capital were 8 percent, the government's effective equity stake would be down to zero. This suggests a fundamental and sensible trade-off: more capital, reduced intrusive regulation. But want to run with less capital? You get the intrusive regulation.

In other words, the CHOICE Act says to U.S. banks: "You don't like the endless additional regulation imposed on you by the bloated Dodd-Frank Act. Well, get your equity capital up high enough and you can purge yourself of a lot of the regulatory burden, deadweight cost and bureaucrats' power grabs which were all called forth by Dodd-Frank."

CHOICE does not set up higher capital as a mandate or an order to increase the bank's capital. Rather it offers a very logical decision to make between two options. These are:

1. **Option One:** Put enough of your equity investors' own money in between your creditors and the risk that other people will have to bail the creditors out if you make mistakes. Mistakes are inevitable when dealing with the future, by bankers, regulators, central bankers and everybody else. The defense is equity capital; have enough so that the government cannot claim you are living on the taxpayers' credit, and therefore cannot justify its inherent urge to micromanage.
2. **Option Two:** Don't get your equity capital up high enough and instead live with the luxuriant regulation of Dodd-Frank. This regulation is the imposed cost of, in effect, using the taxpayers' capital instead of your own to support your risks.

I believe the choice thus offered in the proposed act is a truly good idea. To my surprise, *The Washington Post* editorial board agrees. They write:

> *More promising, and more creative, is Mr. Hensarling's plan to offer relief from some of Dodd-Frank's more onerous oversight provisions to banks that hold at least 10 percent capital as a buffer against losses…such a [capital] cushion can offer as much—or more—protection against financial instability as intrusive regulations do, and do so more simply.*

Very true and very well-stated.

Making the choice, banks would have to consider their cost of capital versus the explicit costs and opportunity costs of the regulatory burden. Some might conclude that Option Two would yield higher returns on equity than Option One; some will conclude that Option One is the road to success. I imagine some banks would choose one option, while some would choose the other.

Different choices would create a healthy diversification in the banking sector. They would also create, over time, a highly useful learning experience for both bankers and governments. One group would prove to be sounder and to make greater contributions to economic growth and innovation. One group would, in time, prosper more than the other. The other group will end up less sound and less successful. Which would be which? I think the group with more capital, operating in relatively freer markets with

greater market discipline, would prove more successful. But we would find out. Future think-tank fellows could write highly instructive papers on the contrast.

Of course, to establish the proposed choice, we have to answer the question: how much capital makes is high enough? For a bank to make the deal proposed in the CHOICE Act, it would have to have a tangible leverage capital ratio of at least 10 percent. That is a lot more than current requirements, but is it enough?

Consider the matter first in principle: without doubt there is *some* level of equity capital at which this trade-off makes sense—some level of capital at which everyone, even habitual lovers of bureaucracy, would agree that the Dodd-Frank burdens become superfluous or, at least, cause costs far in excess of their benefits.

What capital ratio is exactly right can be, and is, disputed. Because government guarantees, subsidies, mandates and interventions are so intertwined with today's banks, there is simply no market answer available. Moreover, we are not looking for a capital level which would remove all regulation—only the notorious overreaction and overreach of Dodd-Frank. For example, the CHOICE Act requires to qualify for Option One that, in addition to 10 percent tangible capital, a bank must have one of the best two CAMELS ratings by the regulator—"CAMELS" being assessments of capital, asset quality, management, earnings, liquidity and sensitivity to market risk.

Numerous proposals for the right capital levels have been made. However, the fact that no one knows the exact answer should not stop us from moving in the right direction.

Among various theories and studies, the International Monetary Fund concluded that "bank [risk-based] capital in the 15-23 percent range would have avoided creditor losses in the vast majority of past banking crises," and that this range is consistent with "9.5 percent of total leverage exposure." Obviously, a 10 percent level is somewhat more conservative than that.

Economist William Cline recently concluded that "the optimal ratio for tangible common equity is about 6.6 percent of total assets and a conservative estimate…is about 7.9 percent."

Paul Krugman proposed a maximum assets-to-capital ratio of 15:1, which is equivalent to a leverage capital ratio of 6.7 percent. Anat Admati and Martin Hellwig came in much higher, arguing for a leverage capital requirement of 20 percent to 30 percent – however, with no empirical analysis. Economists David Miles, Jing Yang and Gilberto Marcheggiano estimated optimal bank capital at about 20 percent of risk-weighted assets, which in their view means a 7 percent to 10 percent leverage capital ratio.

In a letter to the *Financial Times*, a group of academics asserted a requirement for 15 percent leverage capital, but a study by economists Anil Kashyap, Samuel Hanson and Jeremy Stein proposed risk-based capital of 12 percent to 15 percent, which means a leverage capital ratio of 6 percent to 8 percent. Banking expert Charles Calomiris proposed 10 percent leverage capital.

All in all, it seems to me that the 10 percent tangible leverage capital proposed in the CHOICE Act to qualify for Option One is a fair level. It subtracts all intangible assets and deferred-tax assets from the numerator of the ratio, and adds the balance sheet equivalents of off-balance sheet items to the total assets in the denominator. Thus, it is a conservatively structured measure.

In 2012, Robert Jenkins, then a member of the Bank of England's Financial Policy Committee, gave a speech to the Worshipful Company of Actuaries entitled "Let's Make a Deal," which put forward the same fundamental idea as does the CHOICE Act. The proposed deal was a "rollback of the rule book" in exchange for banks raising "their tangible equity capital to 20 percent of assets." He explained the logic as follows:

• "We all agree that too many bankers got it wrong."

• "We acknowledge that too many *regulators* got it wrong."

• So, the best solution is to increase the tangible equity and "in return we can pare back the rule book—drastically."

Under the CHOICE Act, in exchange for 10 percent tangible leverage capital, along with a high CAMELS rating, the deal is, to repeat, not to eliminate all regulation, but to exit from the excesses of Dodd-Frank. We should view Dodd-Frank in its historical context, as an expected political overreaction to the then-recent crisis. Now, for banks taking Option One, there would still be plenty of regulation, but not the notoriously onerous entanglements of Dodd-Frank. In exchange for Jenkins' suggested move to 20 percent leverage capital, one would rationally eliminate a *lot* more regulation and bureaucratic power—to pare it back, as he says, "drastically." The proposed act is more moderate.

The CHOICE Act uses the simple and direct measure of tangible leverage capital. This is, in my judgment, superior to the complex and sometimes opaque measures of risk-adjusted assets and risk-based capital. Although, in theory, risk-based capital might have been attractive, in fact, its manifestations have been inadequate, to say the least. Risk adjustments assume a knowledge in regulatory bureaucracies about what is more or less risky that does not exist—because risk is in the future. They are subject to manipulations and mistakes and, more importantly, to political factors. Thus, for example, Greek sovereign debt was given a zero risk weighting and ended up paying lenders 25 cents on the dollar. The risk weightings of subprime MBS are notorious. Fannie Mae and Freddie Mac debt and preferred stock were given preferential risk weightings, which helped inflate the housing bubble—a heavily political decision and a blunder.

The deepest problem with risk weightings is that they are bureaucratic, while risk is dynamic and changing. Designating an asset as low risk is likely to induce flows of increased credit, which end up making it high risk. What was once a good idea becomes a "crowded trade." What was once a tail risk becomes instead a highly probable unhappy outcome.

Of course, no single measure tells us all the answers. Of course, managing a bank or supervising a bank entails understanding multiple interacting factors. But for purposes of setting up the choice for banks in the proposed act, I believe the simplicity of tangible leverage capital is the right answer.

In my judgment, the proposed choice between Option One and Option Two makes perfect sense. It takes us in the right direction and ought to be enacted.

Thank you again for the chance to share these views.