

“Post-Crisis Risks and Bank Equity Capital” -- Remarks by FDIC Vice Chairman Thomas M. Hoenig, presented to the 18th Annual International Banking Conference at the Federal Reserve Bank of Chicago

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It has been a rugged decade for the global economy, its financial firms, and their regulators. The economy has experienced crisis, followed by bail-outs, followed by thousands of pages of laws and regulations designed to address the deficiencies. However, for all this activity, people remain highly uncertain about what to expect from our economic institutions in the decade ahead. The dimensions of this uncertainty ultimately will depend on the choices and standards of performance demanded of those institutions today. It is with this in mind that I want to discuss one such standard -- the role of capital -- in the context of the conference theme: the future of large, internationally active banks.

I acknowledge that progress has been made in strengthening our financial institutions. Capital and liquidity positions of large banking organizations have improved since the crisis. I also acknowledge that stronger rules and more demanding regulators have played a role in achieving this improvement. Nevertheless, progress has been modest at best, and with the rich incentives that come from the safety net, there is constant pressure to compromise boundaries intended to strengthen the system. An example of the important decisions pending in the international arena is the Basel Committee’s announced intention to review the calibration of its leverage ratio framework, after only recently recognizing its importance. My message, therefore, is that while there has been progress improving capital, much remains undone and there is no place for complacency regarding the stability of our financial system.

Two Regulatory Options: Risk Prediction or Equity Capital

To begin, global banks are not as well capitalized as some within the industry would have you believe. The fact is they remain highly leveraged and highly complicated, and should one fail, it would have systemic, destabilizing consequences. There are two different ways to address these concerns. One would require detailed rules to control firms' behaviors, structure their balance sheets, and direct their activities. The latest example is the Federal Reserve's minimum debt proposal, recently put out for discussion, that would require firms to issue additional long-term debt that would turn to equity when needed in order to increase their "total loss-absorbing capacity." But it is costly to service this debt, putting earnings pressure on firms and their units that – all else being equal – could accelerate failure should an institution run into financial trouble. This goes to the core of our discussion about the fundamental need for equity, versus debt, to make a financial system strong. A question we must ask, then, is whether the effect of such a requirement that is designed to make a firm more resolvable once that firm has failed, could -- prior to failure -- increase the firm's leverage and thereby its likelihood to default. Our goal to prevent failure should be every bit as important as resolving failed firms.

The other way to promote stability would be to simply demand more equity capital to enable banking firms to better withstand a crisis, while allowing them to run their businesses with less government direction.

The first option would require regulators to predict what activities and investments might cause future crises. It also would require them to calibrate rules in a manner that wouldn't give rise to subsequent crises. In other words, regulators would have to successfully anticipate the

source of future crises, which as you know could arise from a number of activities, but mostly likely will come from something we fail to predict.

The second approach is based on equity capital and thus would not require such extraordinary insight from regulators. By design, it acknowledges that regulators cannot predict events and it ensures a safer system because well capitalized institutions are better able to withstand shocks and survive crises. Using simple leverage measures instead of risk-based capital measures eliminates relying on the best guesses of financial regulators to guide decisions.

Ever-Changing Sources of Risk

Bank balance sheets today hold a range of assets that are unavoidably more sensitive to changes in interest rates than even just prior to the crisis. The near-zero short term interest rates of the post-crisis period have boosted the value of stocks and bonds, and they have encouraged increased leverage through low-cost borrowing at extended maturities. For example, the average maturity of newly issued corporate bonds is approaching 15 years, according to SIFMA data.

What zero interest rates give, rising interest rates can take away. Bond arithmetic tells us that the value of many long maturity, low coupon fixed income bonds issued in recent years can be expected to decline sharply in response to increases in interest rates or credit spreads, or just the expectations of such changes. Experience also tells us that additional risk can come from unpredictable flash events of heightened volatility for those financial assets that are electronically traded and at high speed.

While financial institutions are used to dealing with changes in interest rates, keeping them artificially at the zero bound for so long changes the calculus of this risk. The volume of fixed income obligations in the system, whose value is highly sensitive to interest rates, is large

and growing. For the largest banks, unrealized losses on available for-sale securities will be passed through to regulatory capital, appropriately so. But this is an added risk factor with which they have previously not had to deal. Also, during the next rising rate cycle, pent-up customer demand for yield may force banks to re-price their deposits faster than has historically been the case. Lastly, how retail investors in bond funds would respond to a rising rate cycle is uncertain, as are the knock-on effects of large selling pressure by these funds.

Then there is the derivatives market, which the largest global banks continue to dominate and where they hold significant exposures. Notional values of derivatives held by FDIC-insured institutions exceeded \$200 trillion at mid-year 2015. It is often pointed out that most U.S. interest rate swaps and CDS index swaps are now cleared and information on these derivatives is reported to trade repositories. Notional volumes have come down as a result of trade compression, and an enhanced margin rule recently finalized should further encourage clearing. Still, by some measures, derivatives exposure is a larger exposure category for banks today than just prior to the crisis. Net current credit exposure for derivatives at insured U.S. commercial banks and savings associations is about twice the pre-crisis average, according to the OCC's most recent Quarterly Derivatives Report.

Further, while the increased use of clearing has changed the locus of these exposures, it has not lessened risks to the system. The migration of standardized derivatives to clearing was a policy decision intended to make the system safer, but without question it elevates the systemic importance of safe and sound operations by central counterparties (CCPs). The potential for unanticipated events and risks, including resolution challenges, associated with the growing use of CCPs is a subject of concern to many observers and is being studied by international groups.

One potential source of trouble, for example, involves CCPs lowering their margin requirements, which is analogous to banks competing for loans by weakening their underwriting standards. If underwriting or margins are lessened too much, exposures mount quickly and often unexpectedly. In this context the capital that a CCP holds typically is relatively small in relation to the volume of its derivatives business. The market tends to downplay this because clearing members' guarantees place the risk of client nonperformance on their member banks rather than the CCP. However, this simply punts the risk down the field. The risk still ultimately is against the capital of the CCP's member banks. Thus, the use of CCPs may not provide as much comfort as we might have intended. The Basel leverage ratio, which has been adopted for the largest firms in the U.S., requires banks to hold a small amount of capital against the potentially unlimited guarantee they provide to the CCP. Nevertheless, efforts continue to try to reduce or eliminate the capital they hold against this guarantee. If this were to be allowed, large amounts of economic exposure to derivatives -- significant financial leverage and risk -- would vanish from the regulatory capital radar screen, encouraging even larger volumes of interlinked and opaque derivatives activity. Such an outcome strikes me as a counterintuitive abandonment of post-crisis regulatory initiatives.

Another troubling source of market volatility and uncertainty is "the great bear market in commodity prices" that has persisted throughout much of the post-crisis period. The Bloomberg commodity index, for example, which tracks the prices of major industrial raw materials, had – as of last week – declined 63 percent from its July 2008 peak to its lowest level since 2002.¹

¹ Headline commodity index, <http://www.bloombergindeces.com/resources/>, accessed October 26, 2015.

Important industry sectors such as energy and shipping have come under pressure, along with individual firms with leveraged exposure to commodities. Complicating matters further are the linkages in both directions between commodity prices and financial markets. For example, some analysts have suggested that a tremendous expansion and subsequent contraction of structured finance and swaps activity related to commodities was an important driver of the pre-crisis commodity price boom and its subsequent collapse.² In the other direction, lost revenues from the sale of commodities by emerging market countries can drain their reserves and affect currency prices and the performance of a variety of financial contracts.

Finally, we cannot ignore the reality that international financial linkages across countries are more important now than they were even just five years ago. For example, the deep concern expressed by policymakers that Greece, a country with a GDP smaller than that of Louisiana, might default or exit from the Eurozone suggests in part wariness about potentially unknowable financial linkages and knock-on effects in this interconnected world. The extent to which changes in Chinese economic activity can reverberate on Wall Street further emphasizes the fragility of such linkages. And of course, U.S. developments with respect to our own federal debt limit are closely tracked overseas because of their potential ripple effects.

At another level, international linkages are growing not only across legal boundaries but also within our largest banking organizations. For example, the proportion of derivatives activity in the lead IDIs of the eight U.S. G-SIBs that is conducted from their foreign offices increased from 43 percent at yearend 2009 to 51 percent at yearend 2014. Exposures recorded as “net due

² See, e.g., <http://ftalphaville.ft.com/2012/05/08/990211/the-subpriming-of-commodities/> and <http://www.cnbc.com/2015/01/06/not-just-oil-are-lower-commodity-prices-here-to-stay.html>, accessed October 26, 2015

from” amounts that these IDIs have to their Edge corporation subsidiaries and other foreign subsidiaries increased from less than \$2 billion at yearend 2009 to almost \$200 billion at yearend 2014. I am not suggesting any specific safety and soundness concerns by mentioning these numbers, but I am suggesting that the potential for transmission of unanticipated risks across international boundaries does not appear to be diminishing with time -- quite the opposite. These are not risks that I suggest banks should run from, but they are risks that banks must acknowledge and be prepared to absorb. Saying your risk models take care of it is not credible.

Some of these sources of risk undoubtedly have been fed by current regulations designed to direct banks’ activities in accordance with regulators’ views. For example, banks levered up on sovereign debt of nations such as Greece due to the zero risk-weighting given by “risk-based” rules. Trying to avoid crisis by directing activity and favoring certain investments to avoid crisis has not proven successful so far, and I am doubtful it ever will. Rather, the banks that historically have best weathered crises are the ones with strong equity capital.

Trust Built on Equity Capital

We hear often that trust and confidence in a system is necessary for it to successfully grow and create wealth. In the last crisis, analysts didn’t trust banks’ risk models – they trusted equity capital. This capital is a necessary ingredient to building that trust. It will help ensure that banks can survive liquidity runs because someone will continue to lend to institutions that are still demonstrably solvent, and it will make failure – or need for bailout -- less likely. Perhaps most importantly, strong capital will not require regulators to pick favored investments and put strict, complicated restrictions on an ever-growing set of activities.

The next question, then, is how have we done at promoting this cushion of equity? I estimate that for the eight U.S. G-SIBs, a simple measure of tangible equity to tangible assets on the balance sheet comes to about 7.7 percent for the group as of mid-year 2015. When the firms' balance sheets and this ratio are adjusted, using estimates of International Financial Reporting Standards (IFRS), to measure derivatives exposure, the equity cushion for the group shrinks to about 5.7 percent of exposure.³ That is barely two percentage points higher than what these largest banks held as an industry when they entered the crisis, and it is unlikely to be adequate to maintain market confidence should we encounter any major recession or significant deterioration in asset values.

I have been told that a G-SIB needs less capital because it is more diversified than smaller regional banks. But G-SIBs today are more exposed, not less, to the types of common market-based, interconnected, and opaque financial risks that move together and too often undermine stability. And of course, their operations now are more, not less, integral to financial markets that so decisively control the performance of the broader economy.

Costs of Capital

What about concerns for the costs of capital? The effect of higher capital on a bank's foregone tax deductions, cost of funds, return on equity, industry ranking, and management bonuses are important for banks, of course, but these factors cannot be judged in isolation. A more complete question from a system-wide perspective includes asking whether higher levels of bank capital affect sustainable levels of economy-wide consumption and output over time.

³ For further information and data, see the Global Capital index:
<https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio2015-2.pdf>

In this respect and for the ranges we are talking about, the system-wide benefits of strong equity capital would appear to far exceed the aggregate economic costs over the business cycle and thus should not be ignored. In the last crisis, for example, data show that better capitalized banks failed less frequently and were able to maintain lending more effectively than their less well capitalized counterparts.⁴ I would add further that, on a relative basis, current media coverage suggest that better capitalized U.S. banks are currently outperforming their less well capitalized European counterparts.

Conclusion

Let me end by emphasizing that in the absence of government bailouts, a successful financial industry requires strong equity capital -- and then good assets and earnings supported by this capital. ROEs might be boosted in the short term using excessive leverage, but that is almost never sustainable in the longer run. Thus, bankers and their regulators cannot afford to fall into the old habit of thinking when times are good that equity capital is merely a cost to the system.

Policymakers involved in capital regulation, including the Basel Committee as it proceeds with its review of the calibration of the leverage ratio, should take seriously the benefits of a strong foundation of equity capital, best measured using a leverage ratio. Contrary to some claims, equity capital in fact supports sustainable risk taking over the course of the cycle by removing the necessity of regulators to pick winners and losers, thus allowing the owners of the

⁴ Capital and lending ratios:

<https://www.fdic.gov/about/learn/board/hoenig/Lending%20through%20the%20cycle.pdf>

Failed bank capital ratios:

https://www.fdic.gov/about/learn/board/hoenig/Failed%20Bank%20Capital%20Ratios%20at%20YE%202007_03%2026%202015.pdf

capital to take their own risks, run their own firms, and absorb their own losses without public support.

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The views expressed are those of the author and not necessarily those of the FDIC.

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