Toward a Safe and Sound Financial System

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I am very pleased to testify on financial soundness before this committee. Much has changed since the financial crisis of 2008. I will comment on the adequacy of some of the measures and propose some more effective procedures including passage by the Congress of the Brown-Vitter legislation.

Let me begin by stating two principles that should guide your efforts.

First principle: legislation should increase incentives by bankers and financial firms to act prudently. In an uncertain world, we cannot always know the prudent course. Owners and managers are most likely to act prudently, if they bear the cost of errors, mistakes, and unforeseen events. They will be more willing to cushion risks and uncertainties.

Second principle: regulation must provide rules that prevent single bank failures from threatening the financial system. More than a century ago, careful analysts understood that the public responsibility was to protect the payments system because a breakdown of the payments system stops all or most economic activity. Fear and uncertainty cause banks to refuse to accept payments drawn on other banks.

That is what happened in the Great Depression. That was what started to happen in 2008 after Lehman Brothers failed. Timely, aggressive action by the Federal Reserve prevented the payments breakdown.

The second principle has wrongly devolved into actions to protect banks. There is no economic justification for that as a public responsibility. I repeat: THE PUBLIC RESPONSIBILITY IS TO PROTECT THE PAYMENTS SYSTEM, NOT THE BANKS OR BANKERS. The proper way to separate the two is to impose procedures that prevent a failing bank from threatening the payment system. That requires four or five actions.

(1) A clearly stated announced rule for the lender-of-last resort. A well-known rule that has been used successfully calls for the Federal Reserve to lend freely on good colateral at a penalty rate. In its first hundred years, the Federal Reserve has often discussed its lender-of-last-resort policy internally, but it has never announced its policy. Announcement is important, indeed crucial. It tells potential users well in advance how to prepare their balance sheets and to hold collateral against which they can borrow from the Federal Reserve in a crisis. It avoids panic by enforcing it announced rule.
(2) It does not wait to choose action until the panic is upon us.
(3) The lender-of-last-resort policy prevents crises from spreading and stopping the payments system. It does not save or help troubled banks that lack acceptable collateral.
(4) Require equity capital at banks sufficient to absorb all anticipated losses. The Brown-Vitter bill requires a minimum of 15 percent equity capital for all banks that hold $ 500 billion in assets. Capital is assessed against all assets, no exceptions or adjustments for risk. This avoids circumvention.
(5) If a bank's equity percentage falls to 10 percent due to losses, it must cease paying dividends until the 15 percent equity ratio is reached.
(6) All money market funds should be marked to market. Recent reform required mark-to-market for institutional funds but exempted individual funds. The problem of runs is not avoided unless all money market funds are covered by a mark to market rule. The purpose is to prevent depositor runs.

Community banks and all banks with less than $ 500 billion in assets should hold a lower equity capital percentage, say 8 percent, because they are protected by deposit insurance.

Banks as a group pay the cost of deposit insurance. It has worked well for all but the largest banks.

The Brown-Vitter bill recognizes that the way to prevent bailouts using taxpayer funding is to

make the bankers have an incentive to be prudent. The 15 percent equity requirement is based on the minimum equity capital ratio held by major New York City banks during the worst financial crisis in our history, 1929-32. By requiring banks to pay for their mistakes, the system gave bankers strong incentives to lend prudently. No major New York band failed.

Bankers make two principal arguments against this proposal. They say it would reduce credit availability and would encourage greater risk taking to restore earnings. Both claims are wrong. The Federal Reserve determines the volume of lending; banks decide who gets the credit. As to increased risk-taking, the banks bear the cost of bad decisions, not the public. Large stockholders would quickly replace managers who caused them heavy losses and jeopardized their dividend.

Dodd-Frank gives the Treasury Secretary the power to decide too-big-to-fail. Since TBTFstarted, it has always been the Treasury Secretary. The mistake in Dodd-Frank is that the Treasury Secretary makes the decision in the midst of a crisis. That's much too late. No one should believe that any Treasury Secretary will risk a bigger crisis at that time. The only way to end too-big-to-fail is to adopt and enforce rules that give the bankers much greater incentives to be prudent and avoid failure. The Brown-Vitter bill does just that.

Finally, consider the complex Volcker rule that requires regulators to decide what is a hedge done to reduce risk and what is a speculation that banks choose to increase risk. Compare that to the much simpler Brown-Vitter requirement that makes the bankers pay for their mistakes and gives them a strong incentive to avoid making them. Which do you think is mostly likely t,o prevent crises and to reward safety and soundness?