

The Financial Regulatory Reform Agenda in 2017*

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Abstract

We take stock of the post-crisis financial regulatory reform agenda. We highlight and summarize areas of clear progress, where post-crisis reforms should either be maintained or built upon. We then identify several areas where the new regulations could be streamlined or rolled back in an effort to reduce the burden on the financial sector, particularly on smaller banks.

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I. Executive Summary

In this note, we take stock of the post-crisis financial regulatory reform agenda. While new regulations have significantly improved the resilience of the financial sector, they have also come with a variety of costs.

We list several areas of clear progress—areas of reform where the benefits from greater financial stability significantly outweigh the associated costs. However, in each area, we highlight areas where further work is needed to cement this progress, appropriately target the most systemic institutions, and reduce regulatory burdens.

- ***Heightened capital regulation***, particularly for the largest banks, has made the financial system more robust in three ways. First, by putting more private capital in a position to absorb losses in a future crisis, heightened capital regulation protects taxpayers. Second, it reduces the distortions associated with the too-big-to-fail problem. And, finally, a well-capitalized banking system can better weather future economic downturns while continuing to provide the credit the economy needs, reducing the risk of another devastating credit crunch like the one that hobbled the economy in 2008 and 2009.
- ***Stress testing and capital planning*** have improved the way that large banks manage their risks and should make it easier to promptly recapitalize the banking system the next time there are large losses.
- ***Liquidity regulation*** is intended to ensure that the largest institutions have sufficient liquidity buffers to withstand dangerous run-on-the-bank scenarios.
- ***Tools to deal with regulatory migration*** are necessary in our fragmented regulatory system, so that financial risk-taking does not evade regulation by migrating across institutional boundaries.
- ***Resolution authority*** gives the government the tools to insulate the economy from the disorderly failure of a large financial institution.

We also identify several areas of post-crisis reform where the regulatory burdens likely outweigh financial stability benefits. These reforms should be modified or rolled back:

- The ***supplementary leverage ratio*** requirement, which is currently pushing banks away from low-risk activities, should be loosened.
- ***Smaller banks***, up to \$250 billion in assets, should be exempted from many of the heightened capital, liquidity, and stress testing rules that have been applied to the biggest banks.
- ***The Volcker Rule*** should be repealed.
- ***Compensation regulation*** at the biggest banks should be substantially simplified, with a focus on a few bright-line rules and an effort to avoid micro-management.

II. Introduction

There is widespread recognition that financial crises can have devastating effects on the broader economy. The disorderly failure of large financial institutions and the collapse of financial markets can cause companies and households to suddenly lose access to credit, leading to a severe recession. Indeed, the 2007–2009 Great Recession was much worse than any recession the U.S. economy had experienced since the Great Depression of the 1930s: the unemployment rate rose from 4.6% in June 2007 to 10.0% in October 2009. Because of the destruction of savings and the lack of access to credit, the financial crisis made the Great Recession more severe than it otherwise would have been. And, there is widespread agreement that the financial crisis contributed to the sluggish rate of growth in the ongoing recovery that began in mid-2009. Furthermore, the taxpayer assistance that the government extended to failing financial institutions in 2008 struck most Americans as deeply unfair, even if it was necessary to avert a full-blown economic depression.

The regulatory response to the financial crisis has had three main objectives: (i) to reduce the likelihood that any large financial institution fails; (ii) to limit the harmful spillovers to the broader economy that would be triggered by the disorderly failure of a large institution; and (iii) to reduce the risk that U.S. taxpayers, rather than private investors, are asked to absorb losses in a future crisis. To reduce the probability that any large financial institution fails, capital and liquidity requirements have been increased substantially and extended to a broader set of large financial institutions. To limit the harmful spillovers from a disorderly failure, policymakers have developed new tools to help manage institutional failure.

These more stringent financial regulations have not, however, come for free. Regulations can increase the cost of credit to companies and households in normal times, consume managerial attention and increase compliance costs, and potentially decrease competition because larger institutions are better able to bear the fixed costs of compliance. Policymakers must strike a balance between costs and benefits: it would not make sense to drive the probability of a future crisis down to zero, because doing so would require regulations that would be too onerous.

In this note, we take stock of those elements of the post-financial crisis regulatory reform agenda that were primarily designed to enhance financial stability. We do not discuss other financial regulations, including those designed to address consumer protection, market power, bank secrecy, and national security.

In Section III, we summarize the core elements of the post-crisis regulatory agenda that we believe should be retained going forward. For each element, we explain how the associated reforms were shaped by lessons learned from the crisis, and why we believe their benefits outweigh their costs. However, we suggest several ways that these core reforms could be improved and streamlined going forward.

In Section IV, we turn to areas of potential regulatory overreach, with the aim of identifying regulations that could be modified or rolled back in an effort to reduce regulatory burdens. A key point we emphasize is that the failure of a large bank is likely to have more harmful spillover effects on the broader economy than the failure of a smaller bank. As a result, heightened regulations should primarily be focused on large financial institutions. While some recent regulations draw a distinction between systemic and non-systemic institutions, we believe that the regulatory burden on non-systemic institutions can be meaningfully reduced.

Over the past year, proposals to reform financial regulation have emerged from the U.S. House of Representatives, the U.S. Senate, and most recently the White House. These reform proposals, which would roll back some elements of the post-crisis regulatory reform agenda, appear motivated by two goals. First, they aim to reduce the regulatory burden on U.S. financial institutions. Second, they aim to reduce the likelihood that taxpayers are forced to bail out the creditors of financial institutions in a future crisis—i.e., to eliminate the “too big to fail” problem. We do not directly address the details of recent proposals here, but our discussion speaks to central elements in these proposals. We are highly sympathetic to the goals of reducing regulatory burden and ending “too big to fail.” However, as we articulate below, the core elements of the post-crisis regulatory agenda listed below are crucial for achieving these goals and promoting the soundness of the financial system and the U.S. economy.

III. Core principles of post-crisis reforms that should be retained

A. Heightened equity capital requirements

Prior to the crisis, financial firms, especially the largest banks, did not have nearly enough loss-absorbing common equity. Having a substantial cushion of equity capital is crucial for three reasons. First, it ensures that bank shareholders, and not taxpayers, bear losses when banks take too much risk. Second, it reduces the distortions associated with the too-big-to-fail problem, whereby big banks with a perceived government backstop are able to borrow at below-market rates, giving them an unfair competitive advantage. Finally, it allows banks to withstand large losses without failing, insulating the broader economy from financial crises. Recognition of this conclusion has driven *heightened capital regulations* designed to significantly boost the amount of loss-absorbing common equity that financial firms have on hand.

Heightened risk-based capital requirements, especially those targeted at the largest banks, are the single most important post-crisis regulatory reform, and it would be a serious mistake to weaken them. And, relative to other post-crisis reforms, increased capital requirements pose a light compliance burden, since they simply require banks to shift their funding from debt capital to equity capital.¹ Under the Basel III agreement adopted in the wake of the crisis, all banks must

¹ This is not to say that higher capital requirements are completely free from the perspective of banks or from that of society as a whole. However, since higher capital requirements shift risk from long-term debtholders to bank shareholders and largely leave the total amount of bank risk unchanged (Modigliani and Miller (1958)), most economists believe that, within limits, higher bank capital requirements have only a minor long-run impact on the

have substantially more common equity relative to risk-weighted assets than they did prior the crisis. Importantly, the largest U.S. banks, whose failure would pose the gravest threat to the economy, now face higher capital standards than smaller banks due to the *Global Systemically Important Bank surcharge*. Furthermore, Basel III’s *capital conservation buffer* recognizes the important principle that banks should be allowed to draw down their capital buffers in a crisis so that they can continue to lend.

Capital regulations should be primarily “risk based,” meaning that banks should be required to hold more equity capital against their riskiest assets. Since the goal of capital regulation is to limit the likelihood of bank failures, banks who hold riskier assets should have larger equity cushions. Furthermore, capital requirements that are not risk-based often have the perverse effect of incentivizing banks to substitute away from safe assets and towards riskier assets. Such perverse incentives created by risk-insensitive capital requirements were a major concern in the mid-1980s, which led to the introduction of risk-based capital standards in the 1988 Basel I Accord.² Any capital requirement that does not consider risk, including recent proposals to “off-ramp” banks that look relatively “safe” based on simple capital measures that do not adjust for risk—such as the leverage ratio—will have this undesirable feature.³

B. Stress testing and capital planning

Prior to the crisis, many of the largest financial firms were incapable of adequately assessing the chance that they would suffer large losses that could lead to their failure. Risk management took place at the level of individual business lines (e.g., mortgage lending, commercial lending, trading, etc.), but many of the largest institutions had failed to combine these risk assessments into a comprehensive measure of risk at the overall firm level. Furthermore, as large financial firms began to suffer major losses in late 2007, they made little effort to rebuild their capital buffers—either by reducing shareholder payouts or by raising new equity capital—even though they easily could have done so before the peak of the crisis in September 2008.

These failures motivated a post-crisis emphasis on forward-looking *stress testing* and *capital planning* at the largest banks. The Federal Reserve’s annual *Comprehensive Capital Analysis and Review (CCAR)* exercise is designed to assess whether the largest U.S. banks would have enough capital to continue lending to households and companies if there was a

cost of credit to companies and households. For extensive discussion on the potential costs of higher capital requirements, see Kashyap, Stein, and Hanson (2010), Admati (2014, 2016), and Baker and Wurgler (2015).

² In 1981, U.S. regulators introduced capital requirements based on a simple leverage ratio—equity capital divided by total assets. Worries soon arose that these risk-insensitive capital requirements were leading banks to substitute away from low-risk, liquid assets and towards high-risk assets and off-balance sheet assets. In response, the Federal Reserve, FDIC, and OCC all proposed risk-based capital standards in 1986, which were then adopted internationally in the 1988 Basel I Accord (Wall (1989)), Federal Deposit Insurance Corporation (1997).

³ The same argument explains why deposit insurance premiums paid by banks should depend and currently do depend on the risks they take.

severe economic downturn. Furthermore, the CCAR assesses whether banks have robust forward-looking capital plans detailing how they will rebuild capital following a significant loss.

The Fed’s stress testing regime is one of the most useful regulatory innovations put in place since the crisis. These annual stress tests help to make the risk-based capital framework more dynamic and forward-looking. This is especially helpful during periods like late-2007 and early-2008, when banks are sitting on large unrealized losses and need to be pushed to quickly recapitalize. And, many executives at large banks have publicly acknowledged that the annual CCAR exercises have made their firms better at managing risk.⁴

Having said this, an area of ongoing concern is the degree of transparency in the Federal Reserve’s stress-testing process. This is a complicated issue, with some difficult tradeoffs to be made. On the one hand, if the Fed is free to significantly vary the parameters and modeling assumptions that underlie the stress tests each year without letting the tested banks know all the details, compliance becomes more costly and consumes more of senior management’s time and attention. And there may be a sense of arbitrariness, or lack of regulatory due process. On the other hand, some amount of opacity is probably necessary for preventing regulatory arbitrage, since if the banks know exactly the parameters of all the Fed’s models, it may be easier for them to load up on those risks that are given least weight in these models, and hence that have the lowest implied capital charges—precisely the activity that the stress-testing procedure is meant to dissuade. A related concern about increased transparency is that fully specifying the test parameters may cause different banks to make more correlated lending decisions, increasing the chances of a system-wide problem.

While there are no easy answers, it is incumbent on regulators to take the above tradeoff seriously, and to develop a principled approach that allows more transparency to be provided in those cases where doing so does not undermine the fundamental integrity of the stress-testing process. For example, it may make sense for the Fed to provide relatively more transparency about its models when stress testing a bank’s consumer loan book than when stress testing its trading operations, because in the latter case there is more scope for the portfolio to be rapidly reshuffled in an effort to game a fixed set of test parameters.

C. Heightened liquidity requirements

Prior to the crisis, many large financial firms engaged in excessive amounts of maturity transformation, financing long-term, illiquid assets with short-term debt and uninsured deposits. Since these short-term creditors aggressively withdraw funding in turbulent times, excessive maturity transformation increases the likelihood of dangerous “run on the bank” scenarios.

This risk can arise even if banks are reasonably well capitalized. Capital regulations are designed to ensure that banks can survive significant losses in an economic downturn if they are

⁴ “Banks to Trump: Don’t Kill Dodd-Frank”, *Wall Street Journal*, December 8, 2016.

not forced to sell their assets prematurely. However, a bank doing a lot of maturity transformation may be forced to prematurely sell its illiquid assets in order to pay off short-term creditors who withdraw funding when trouble arrives. Losses from being forced to sell assets at fire-sale prices can trigger the failure of a large bank, even if it was adequately capitalized.

Basel III's "*liquidity requirements*" are designed to address this problem by limiting maturity transformation at large banks. Specifically, policymakers have introduced two complementary liquidity requirements for large banks in the wake of the crisis. First, the *Net Stable Funding Ratio (NSFR)* is designed to directly curb maturity transformation, limiting the extent to which banks can finance long-term, illiquid assets using run-prone, short-term debt. Second, the *Liquidity Coverage Ratio (LCR)* is designed to ensure that large banks have enough cash and other high-quality liquid assets on hand to meet withdrawals during a severe 30-day run scenario. In other words, the LCR is effectively a modern day "reserve requirement" for large banks.

These new liquidity requirements are well-motivated, and for the most part sensibly-designed. However, it should be borne in mind that, in contrast to capital requirements—which have been around in one form or another for a long time—these liquidity rules are new and relatively untested. So unintended consequences may emerge, although this has not yet been the case. For example, because the LCR may consume large quantities of high-quality liquid assets like Treasuries, it could potentially create a costly and unnecessary shortage of such assets. In addition, it is not yet clear whether banks will prove willing to draw down their liquidity buffers in a stressed liquidity scenario; if they don't, the regulation will not be able to fully deliver on its promise. Thus, regulators should closely monitor these issues in the coming years, and be open to making adjustments to the new liquidity rules as new information becomes available.

D. Tools to deal with "regulatory migration"

"Regulatory migration," the tendency of financial activity to flow towards the areas with the lightest regulation, is ubiquitous. For instance, the run-up to the financial crisis saw the rapid growth of the "shadow banking" system, with more and more deposit-taking and lending activity occurring outside of traditional regulated banks. Because the shadow banking system had become an important source of credit to the U.S. economy, its collapse from mid-2007 to late 2008 played a central role in the crisis. Going forward, financial policymakers need to be mindful of the risk that activities that may threaten the broader financial system and the overall economy can migrate from regulated firms and markets to unregulated ones.

Relatedly, heightened capital and liquidity regulations are needed to prevent the failure of large financial firms from harming the broader economy, regardless of whether those firms are banks in the formal legal sense or not. For example, the massive insurance company AIG became a key protagonist in the 2007–2009 financial crisis when AIG's imminent collapse threatened to bring down the entire financial system. Thus, regulators must retain the ability to

subject large, complex nonbank financial firms to heightened prudential regulations if such firms could threaten the broader economy.

The risk of migration is exacerbated in the U.S. because of the patchwork nature of the regulatory architecture. The large number of financial regulators invites jurisdiction shopping, whereby financial activity flows in the direction of the most lenient regulator. In addition, because jurisdictional boundaries are not always clearly defined, there is substantial scope for risky activity to fall in the regulatory cracks. Finally, the large number of regulators can lead to overly complicated rule-making and correspondingly high compliance costs.

Under the Dodd-Frank Act, the *Financial Stability Oversight Council (FSOC)* is the entity responsible for monitoring systemic risk and its migration across jurisdictions. While it is crucial to have such a systemic risk monitor, we believe that the existing structure and process could be improved upon. The structure of the FSOC is cumbersome, making it difficult for regulators to act in a timely and predictable manner. It is worth considering alternative and potentially leaner structures, such as the President's Working Group on Financial Markets, for the systemic risk monitor. At the same time, it crucial that any such alternative group be given enough statutory authority that it can actually affect needed changes.

With this point in mind, it is worth noting one area where the FSOC was able to successfully address concerns about regulatory migration: in the *money market mutual fund (MMMF)* sector. Prior to the crisis, MMMFs offered a savings product that was very similar to bank checking deposits: \$1 invested in an MMMF could almost always be withdrawn at face value (\$1) immediately. However, MMMF shares were not as safe as checking deposits: despite being backed by risky assets, they were not insured and were not subject to capital and liquidity regulations like traditional banks. This made MMMFs vulnerable to runs, as occurred in September 2008.

Since the crisis, the FSOC has constructively pushed the SEC—the primary regulatory agency in this case—to reform MMMF regulation in order to safeguard financial stability. The SEC responded with a new set of rules in 2014. Under those new rules, institutional MMMF shares that are backed by risky assets can no longer promise savers a fixed \$1 claim: a saver who invests \$1 in these MMMFs now clearly faces the risk that she will only be entitled to withdraw, say, \$0.97 tomorrow. In addition, these MMMFs now have the ability to impose withdrawal fees and to temporarily suspend withdrawals in a run.

This episode illustrates the importance of having a systemic regulator with the legal authority to react when risky activity crosses jurisdictional boundaries. Absent the process spearheaded by the FSOC, these MMMF reforms would likely not have been implemented.

E. Tools to facilitate the orderly failure and reorganization of large, complex financial firms

A key lesson of the crisis is that a special resolution regime is needed to facilitate the orderly failure of large, complex financial firms. The U.S. bankruptcy code is well-designed for non-financial firms, allowing them to maintain their ongoing operations as they restructure. However, the bankruptcy code is not well-suited to the task of managing the failure of certain financial services firms—especially banks, insurers, and brokers—whose normal operations involve taking on special customer liabilities such as deposits or insurance contracts. Instead, the U.S. has special resolution regimes for financial firms. For instance, the Federal Deposit Insurance Act allows smaller banks to fail in an orderly way that generates minimal disruptions for retail depositors. However, the FDIC’s powers are inadequate to manage the failure of a large, complex financial firm. And, as the failure of Lehman Brothers in September 2008 vividly demonstrated, the disorderly failure of such a firm can impose severe costs on the broader economy.

Three new policies enacted after the crisis have created a new specialized resolution regime for large, complex financial firms: the *Orderly Liquidation Authority (OLA)* created under Title II the 2010 Dodd-Frank, the FDIC’s *Single Point of Entry (SPOE)* resolution strategy, and the Federal Reserve’s *Total Loss Absorbing Capacity (TLAC)* requirements for the very largest financial firms. The goal of these reforms is to ensure that the stockholders and long-term debtholders of large financial firms—and not taxpayers—bear the losses associated with any future failures. At the same time, the reforms are designed to ensure that a large financial firm can fail in an orderly way that maintains normal operations as the firm undergoes a financial reorganization, limiting the significant spillovers to the broader economy that would arise if it suddenly ceased operations.

These reforms have been a major step forward for two reasons. First, they have increased the likelihood that a large financial firm could undergo an orderly failure, making the economy less vulnerable to crises. Second, the reforms have helped address the “too-big-to-fail” problem, reducing the implicit guarantees which benefited large financial firms prior to the crisis. Because it is now possible for long-term debtholders to suffer losses in an orderly failure, they should be more discriminating in who they lend to. Indeed, as concrete evidence of this proposition, the credit rating agencies have reduced their ratings on long-term debt issued by large U.S. financial firms because they no longer expect debtholders to benefit from taxpayer support.⁵

Title II of Dodd-Frank has been controversial because it includes a provision allowing the Treasury Department to act as a temporary lender to a bank as it is being resolved—much like a debtor-in-possession lender in a conventional bankruptcy. This provision strikes some as increasing the likelihood of government bailouts. But the opposite is more likely to be true: without a resolution mechanism that has a credible chance of working, we will be right back to the situation pre-Lehman Brothers. And when we are staring into the abyss, as the country was after Lehman’s disorderly failure, anti-bailout resolve tends to weaken, and ultimately taxpayers

⁵ See “Moody’s concludes review of eight large US banks,” *Moody’s Investor Services*, November 14, 2013 and “U.S. Global Systemically Important Bank Holding Companies Downgraded Based On Uncertain Likelihood Of Government Support,” *Standard and Poor’s*, December 2, 2015.

are asked to write a check. Better to have a mechanism that allows the Lehmans of the world to fail in a way that imposes less damage on the broader economy. This is not to say that concerns about the government lending to firms on the brink of failure are not valid—they absolutely are. But these concerns are more constructively addressed by further strengthening banks’ total loss-absorbing capacity, so that there is effectively a very substantial fresh injection of equity at the point of resolution that protects the government’s position as a prospective lender.

IV. Concrete areas for improvement

A. The Supplementary Leverage Ratio

One area where capital regulations should be adjusted is the *Supplementary Leverage Ratio (SLR)* that is applied to the largest banks. In contrast to standard risk-based capital requirements, the SLR is blind to asset risk. It requires large banks to have equity capital that exceeds a specified fraction of total assets, regardless of their risk; for example, a Treasury bill is treated the same as a loan to a junk-rated firm. The SLR was motivated by the recognition that standard risk-based capital requirements are inherently imperfect: they will never perfectly capture true asset risk and are subject to gaming. Thus, the goal of the SLR was to serve as a backup for risk-based requirements that would guard against errors.

This approach has some merit. The problem with the current implementation of the SLR, however, is that it has been calibrated too aggressively. As a result, it has distorted risk choices, discouraging some banks from investing in the safest assets. These distortions have already had an adverse effect on the functioning of the Treasury market. We would urge that the SLR be dialed back, so that it serves only as a secondary backup to the risk-based capital regime, and is not among the primary regulatory constraints that banks face.

B. Streamlining regulations for smaller banks

Several of the post-crisis reforms discussed above have also been applied to smaller banks, which pose less systemic risk. Moreover, the cost of regulatory compliance, per unit of assets, is higher at smaller banks due to economies of scale in compliance. Thus, it is worth thinking carefully about opportunities for reducing the regulatory burden on smaller community and regional banks.

- **Tailor prudential standards based on bank size.** Section 165 of the Dodd-Frank Act directed the Federal Reserve to adopt more stringent prudential standards for large banks with assets exceeding a specified threshold, including heightened risk-based capital requirements, minimum liquidity requirements, resolution planning (“living wills”), and an annual stress test run by the Fed. The Dodd-Frank Act imposed a minimum asset threshold of \$50 billion for each these heightened regulations, but granted the Federal Reserve (pursuant to a recommendation by the FSOC) the authority to raise the asset

threshold above \$50 billion. To date, the Federal Reserve has applied these higher prudential standards to all banks with more than \$50 billion in assets.

In order to strike the best balance between the benefits and costs of these heightened regulations, it may make sense for the Federal Reserve to raise this threshold to \$250 billion in assets.

It is also worth flagging the requirement under Section 165(i)(2) of Dodd Frank that all banks with assets over \$10 billion must conduct an annual company-run stress test. Here, if the size threshold is to be raised, it would have to be done by Congress. A reasonable adjustment might be to raise the asset threshold for company-run stress tests from \$10 billion to \$50 billion.

- **Simplify risk-based capital standards for banks under \$50 billion:** Another proposal to ease the regulatory burden on smaller banks would be to move them from Basel III's new standardized risk-based capital regime to a less complex risk-based regime. There should be room to simplify both how the amount of capital (the numerator of the risk-based capital ratio) and how risk-weighted assets (the denominator) are calculated for small banks.

While there are good reasons to try to simplify regulations for smaller banks, it is important to stress that simplicity should not be confused with a lack of robustness. It is critical that *all* banks finance themselves with substantial amounts of common equity capital, even if the details of how the capital standards are implemented vary across bank-size categories. One should not forget, for example, the Savings and Loan debacle that plagued the U.S. economy in the late 1980s and early 1990s; this was a problem primarily of smaller and mid-sized institutions, and yet it too did significant damage to the economy and required costly taxpayer bailouts. Thus, it would be unwise to focus too myopically on the most recent financial crisis, in which the problems were primarily at larger financial institutions.

C. Volcker Rule

The Volcker Rule (Title VI, Section 619 of the 2010 Dodd-Frank Act) forbids banks from engaging in trading activity that does not directly benefit their customers. The intention of the Volcker Rule is to distinguish between “market-making” activities, where banks buy and sell securities in order to provide liquidity to customers, and “speculative” proprietary trading activities, where banks buy and sell securities in order to profit on their own accounts. Banks receive public support through deposit insurance and various other channels, the logic goes, so any risk taking that is not for the benefit of banks’ customers should not indirectly benefit from this support.

There are reasons to be skeptical about the usefulness of the Volcker Rule. By discouraging “speculation” at broker-dealer banks, the rule may dissuade dealers from providing liquidity during a market correction. Most fundamentally, market-making and proprietary trading

are almost impossible to distinguish in practice, making the rule difficult to enforce, while at the same time creating large compliance and supervisory costs. This is not to say that concerns about the risks associated with bank trading operations are unfounded. However, these risks can be more effectively addressed by imposing stiff capital charges on banks' trading books, without attempting to divine whether the underlying trades themselves are driven by market-making or speculative motives. Thus, on balance, we believe that the Volcker Rule should be repealed.

D. Incentive Compensation

Section 956 of The Dodd Frank Act establishes guidelines for incentive compensation at U.S. banks. The basic idea behind Section 956 is a sound one: compensation arrangements for top bank executives should not induce excessive risk taking, particularly for the very largest banks. But the statute has invited overly complicated interpretation by the agencies, and the result has been an undue level of prescriptive micro-management of the compensation process.

There is scope for substantial simplification here. A better approach, following the Squam Lake Group's 2010 recommendations, would be a clear bright line rule, to be applied to the largest institutions: each would be required to withhold a significant fraction of the total annual compensation of all senior managers and material risk takers for several years. The withheld compensation would not take the form of stock or stock options, but rather would be for a fixed dollar amount. Employees would forfeit their holdbacks if the firm failed or otherwise received extraordinary government support. Thus, employees who had their compensation withheld would effectively end up being creditors of their firms, in a very similar position to holding-company bond investors who provide a layer of extra loss-absorbing capacity. This approach to deferred compensation would help to align the incentives of risk takers with those of taxpayers and of society more broadly. And with this simple bright-line rule in place, there would be less need for supervisors to be involved in the compensation process at a more micro level.

V. Conclusion

Financial crises can have a devastating effect on the wider economy. While the risk of another crisis can never be fully eliminated, the reforms put in place since 2010 are, for the most part, a well-conceived effort to contain that risk. As policymakers weigh changes to the regulatory system, they should bear that in mind. At the same time, in this note we have identified ample opportunities for reducing the regulatory burden, particularly at smaller financial institutions.

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