

Project Syndicate

It's the Banking Regulations, Stupid

Mar 17, 2023 | ANTONIO FOGLIA

LONDON – Do more bank “bailouts” amount to more proof that capitalism doesn’t work? Some commentators seem to think so. But what capitalism are they talking about? It has been a long time since there was any trace of market discipline or capitalism in banking, one of the most heavily regulated industries of all. Coming on the heels of the travails of Banco Popular and other banks, the failure of Silicon Valley Bank is another case of an institution collapsing overnight without breaching any of the many prudential regulations by which it was governed.

The 2008 global financial crisis exposed the horrendous mistakes that banking regulators had made in the preceding years. But rather than correcting them and developing a robust understanding of why these errors were committed and how they could be avoided in the future, politicians and the public at the time demanded that supervisory authorities simply double down on regulation. So, that is what they did, and we are now seeing the results.

The main mistake in contemporary banking regulation is the requirement of only a razor-thin capital cushion. This is an artifact of a previous era. It is based on the capital that Japanese zombie banks had in the mid-1990s, reflecting the desire among those writing the Basel rules (the international banking regulation framework) not to embarrass their colleagues at the Bank of Japan.

After the global financial crisis, it was again too embarrassing to recognize the extent of this mistake, so policymakers and regulators settled on a more gradual approach. As a result, since 2007, capital as a share of total assets has risen by less than 30% in Europe and the United States. True, Tier 1 ratios (the ratio of equity and reserves to risk-weighted assets) improved by more, but that was largely achieved by tweaking the rules for calculating the numerator and the denominator. Capital would have tripled if banks had been required to carry the same ratio that hedge funds carry voluntarily for the same level of risk.

AFTER THE GFC, CAPITAL REQUIREMENTS WERE NOT MEANINGFULLY RAISED !

US (all FDIC insured banks)			
Bn USD	Total Assets	Total Equity	Eq/TA
End of 2007	10,733	766	7.14%
End of 2022	22,828	2,112	9.25%
			30%
Eurozone (All ECB monitored banks)			
Bn Eur	Total Assets	Total Equity	Eq/TA
End of 2007	29,494	1,681	5.70%
End of 2022	39,017	2,652	6.80%
			19%

Look at SVB. It had \$200 billion in assets, \$86 billion of which was in residential mortgage-backed securities that are not due for at least ten years, and which are carried on a held-to-maturity basis. At fair value, though, this paper was worth only \$71 billion, implying a \$15 billion loss. That amount was more than enough to wipe out the bank's \$12 billion in capital, and it was written clearly in the bank's 2022 financial statements.

In practice, the prevailing "prudential" regulations allowed SVB to leverage its capital more than tenfold on that book of risky securities. Given the volatility of the assets, that is insane. Even an aggressive hedge fund would not have leveraged such a book by more than threefold. But SVB was allowed to operate and publish a Tier 1 ratio of 12%, well within the "prudential" limits. That brings us to the second major uncorrected mistake of banking regulation: solvency is assumed to rest on a held-to-maturity basis. Even "conservative" banking experts such as John Vickers, a former chief economist of the Bank of England, seem to accept this. But would Vickers leave a deposit with a bank that is insolvent on a mark-to-market basis? No, he would not, and nor did SVB's depositors. When they finally realized what should have been clear for many months, they tried to withdraw their money as fast as they could.

This problem would seem to apply only to the US. In Europe, we have regulated liabilities (through the net-stable-funding ratio) and assets (through the liquidity-coverage ratio), so this kind of mismatch should not happen. But as comforting as this arrangement may be, it also means that the authorities have regulated the interbank lending market out of business – and probably the banks as well. Who will leave a deposit at a bank that can achieve only yields below those of the high-quality liquid assets in which the banks and depositors themselves can invest? Banks will remain confined to the payments business, at least until central bank digital currencies arrive, and transfer that business to the central bankrupters too.

Do we want capitalism or not? If we do, we need to get rid of the failed regulations (and regulators), and end the status quo in which central bankers preside over monetary policies with long, variable, and lagging effects, and hence have an impact on future economic conditions that they cannot predict.

We also need to stop thinking that bank deposits are the only financial asset whose price is fixed at par and guaranteed by the nanny state. If banks financed themselves through traded certificates of deposit, crises like the current one would not happen. SVB's CDs might be priced at 85%, owing to the uncertainty surrounding a liquidation or a recapitalization, but there never would have been a run on the bank. The runs happen only because the first 85% of people in line would get par, while only the last 15% would get zero.

ANTONIO FOGLIA

Antonio Foglia, a board member of Banca del Ceresio, is a member of the Global Partners' Council of the Institute for New Economic Thinking.

<https://prosyn.org/C2Bo47D>

Support Project Syndicate

[Subscribe](#) [Upgrade](#) [Donate](#)

Make your inbox smarter.
Select Newsletters

[Content](#)

[PS Quarterly](#)

[Sections](#)

[Topics](#)

[Archive](#)

[Columnists](#)

[Videos](#)

[Podcasts](#)

[Subscriber Exclusive](#)

[OnPoint](#)

[Longer Reads](#)

[Insider Interviews](#)

[Say More](#)

[Big Picture](#)

[Global Bookmark](#)

[Rewards](#)

[Project Syndicate](#)

[About Us](#)

[Contact](#)

[Careers](#)

[FAQ](#)

[Submission policy](#)

[Newsletters](#)

[Member Publications](#)

[Network](#)

[Syndication](#)

[PS Magazines](#)

[PS Events](#)

[Institutions](#)

