

The Minimum Requirements for Safe and Sound Banking

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The author is Professor Emeritus of Banking and Finance at the University of Houston. These remarks were presented as part of a roundtable discussion at the conference "Safe and Sound Banking: Past, Present, and Future," held August 17–18, 2006, and cosponsored by the Federal Reserve Banks of San Francisco and Atlanta and the founding editors of the Journal of Financial Services Research.

It is a fair conclusion to draw from the papers, comments, and discussion at this conference that there is general agreement that the study done twenty years ago correctly identified the issues crucial to a safe and sound banking system. By itself, that fact is not surprising. I would expect that if you lock five economists in a room for a year you will end up with a reasonable analysis of any financial problem. What is more unusual, and more gratifying in this case, is that the study also came up with, according to the comments at the conference, reasonable recommendations for policy actions. Even more unusual, it appears that the recommendations were actually based on the economic analysis. And most unusual, a significant number of the recommendations—and the most significant of them—have been implemented.

My view is that appropriate banking regulatory policy rests on three vertical columns (I would say "pillars," but that term is taken): a meaningful capital requirement, a good means of monitoring compliance with that requirement, and a closure rule to be enforced when the capital requirement is not met.

There is widespread agreement with respect to the importance of capital but disagreement about implementation of a requirement. The problem is that capital adequacy is affected by risk, and we have not resolved the problem of measuring risk. In fact, we do not even agree on the concept of risk. I have long believed that the relevant risk is loss to depositors and the insurance system, but some believe that risk of failure is also important.

The measurement difficulty is illustrated both by the Basel discussions and by the Federal Deposit Insurance Corporation's (FDIC's) proposed risk-based premium system. Our inability to resolve this issue leads to support for keeping the current FDIC Improvement Act (FDICIA) leverage ratio in effect even after Basel is fully implemented, but some analysts fear that American banks will be at a competitive disadvantage if the leverage ratio approach applies only in America.

This issue is important only if one believes that capital is costly and leverage is valuable. Many bankers and analysts argue that it is leverage that allows a low return

on assets to result in a high return on equity. However, George Kaufman has presented evidence that American banks, which have higher capital/asset ratios than foreign banks, not only have higher income/asset ratios, as one would expect, but also have higher income/equity ratios. Finance theory has something to say about this issue—the Modigliani-Miller analysis tells us that, if markets are efficient (as we all believe them to be), leverage does not add to the value of the firm. If that proposition applied in the world of banking, then we could simply require all banks to maintain a high capital ratio, thereby reducing the risk of failure, at no real cost to the banks.

This argument is not abstract. Over the past several years many cases have been argued in the Court of Federal Claims on just this issue. The litigation grows out of

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the acquisitions of failed thrift institutions during the 1980s, in which the acquirers were allowed to count goodwill arising from purchase accounting as capital. This practice was prohibited by the Financial Institutions Reform and Recovery Act

(FIRREA) in 1989, and the Supreme Court ruled that this legislation represented a breach of contract by the government for which the acquirers could sue for damages. The government argued, with Merton Miller as one of its expert witnesses, that the loss of this regulatory capital represented no economic loss since the affected institutions could simply replace the lost capital by raising “real” capital in the market at “zero” net cost—zero because in efficient markets the cost of the liabilities or equity raised is exactly offset by the expected earnings on the cash acquired. (Miller conceded that the plaintiffs were damaged to the extent of the transaction costs—investment banking and legal fees—of the capital raising.) While the litigation is not finished, enough cases have been resolved to conclude that the courts have accepted this position. Perhaps Basel would have a different outcome if the U.S. delegation had included significant representation from the Justice Department instead of relying solely on the banking agencies, which lack Justice’s familiarity with finance theory.

A way of resolving this issue was strongly endorsed by the authors of *Perspectives on Safe and Sound Banking*. Subordinated debt provides a cushion that protects depositors and the deposit insurance system yet allows banks to be as leveraged as they or the market believes optimal. But this proposal brings us back to the concept of risk that I mentioned earlier—subordinated debt, with its fixed charges, does nothing to prevent failure. If one is concerned with bank failure as a social problem (and not solely with losses to depositors or insurers), then only equity will do.

The importance of a closure rule is widely recognized now, but it was not as well understood twenty years ago. The concept is simple: If capital is greater than zero, there is no loss to depositors from failure; the logical rule is that closure must occur before capital becomes negative. The authors spent a good deal of time in considering this issue. Conceptually, one could close a failing bank at the time its net worth hits zero (that is, the market value of assets equals the market value of liabilities), but, clearly, the ability to measure assets and liabilities and to monitor a bank closely enough to find that precise moment to act does not exist or would be prohibitively expensive. While we did not use the terms “prompt corrective action,” or even “structured early intervention and resolution,” we did call for closure “when the market value of net worth goes below some low, but positive, percentage, such as 1 or 2 percent of assets.”

The problem with this sort of closure rule is that there must be a reliable system to measure capital. Historical cost accounting just doesn’t work for this purpose (though it is probably better suited for financial institutions than for other firms in

which fixed assets make up a large part of the portfolio). Market-value accounting is clearly better if functioning markets exist. They do for the securities that compose part of a bank's portfolio and for mortgage loans that may make up a larger part. No functioning markets exist for most of the other loans and assets that banks hold. For most financial assets and derivatives, pricing models can approximate what the market value would be. This approximation is often referred to as fair-value accounting.

George Benston, a certified public accountant, was at first skeptical but did endorse the authors' support for market-value reporting. I did not really understand his skepticism until Enron. I believed that modeling could generate valid figures—if we have market information on an A-rated, ten-year bond and on the shape of the yield curve, it should be simple to come up with a good approximation of the price of a fifteen-year bond of the same company. I recognized then that models can generate errors even if applied honestly and competently, but after Enron it is clear that skepticism toward the use of internally generated models in measuring capital is justified. As we move toward the Basel endorsement of such an approach, this issue becomes more significant.

Of course, if there is an inclination to commit fraud, reliance on models to determine accounting values provides great opportunities.¹ We know that fraud is a potential problem with any accounting system, but the opportunities to commit fraud are greater when management's judgment, rather than markets, is used to determine values. The tendency to commit fraud is not unrelated to the condition of a bank. During the savings and loan collapse of the 1980s I saw many managements with previously spotless records turn to filing false financial reports. Their intent was (often) not permanent fraud, but they were dealing in what they thought was a temporary, disastrous collapse of real estate prices. If they could avoid writing down an asset for a year, probably its fair or market value next year would be higher (they rationalized). Regardless of the accounting and reporting system, appropriate monitoring by the banking agencies must be concerned with fraud. *Perspectives on Safe and Sound Banking* stressed this point at a time in which bank examiners generally considered fraud to be a matter for auditors rather than examiners.

Although I must confess that the review of the book necessitated by this conference has made me cringe at some passages, I take pride in our ability to identify issues and to point public policy in the right direction. Over recent years we have moved significantly in that direction, but we still have a way to go.

1. In a recent paper, George Benston ("Fair-Value Accounting: A Cautionary Tale from Enron," *Journal of Accounting and Public Policy* 25, no. 4 [2006]: 465–84) explores several examples of the use of fair value accounting by Enron. Most of these examples look like fraud to me, but they passed muster by Enron's auditors (internal and external).

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