COMPLEXITY RISK:
The Mighty Hand Rewriting American Banking

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When I got into the banking business, it was pretty simple – or at least so it seemed to me. To be sure, I knew nothing about banking when I happily accepted a junior-officer position at Bank of America back in the way back. In 1977, I was finishing a Ph.D. in political science. BofA offered me a job analyzing sovereign risk – useful then as now. It sounded interesting even though banking then was said to be dull as molasses. Those of you here as old as I will recall the banker's motto: borrow your money at 3 percent, lend at 5 percent, out on the golf course by 4 o'clock.

That motto, though, changed banking from dull to anything but, leading as it did to the S&L crisis. Borrowing at 3 percent and lending at 5 percent only works if the tenors of the assets and liabilities are in sync, which of course they weren't. When assets stayed at three percent and liabilities soared to fifteen percent or higher, banking went from simple to death-defying, helped off the cliff by an array of ill-omened government decisions.

In the 1980s, we learned the hard way about interest-rate risk. And, now, we have added a whole library of new risks to the litany, with regulators focusing in particular on the credit, liquidity and governance risks they believe sparked the global financial crisis. Regulators don't address this much, but we also learned the hard way in the 1980s and ever since that policy decisions are big risk drivers, with well-intentioned reforms sometimes thwarting market discipline or, worse, protecting bad practice until it becomes the market norm.

All of these risks combine to one that, I think, is the biggest strategic driver facing each of your banks. I call it complexity risk. Why complexity risk? Partly, it's because the sum total of all the new rules makes my head hurt. But, more importantly, it's because the sum total of all of the rules often doesn't make sense, posing the most important strategic question for the industry and its regulators: is the industry in a cyclical decline due to the current recession and short-term regulatory costs? Or, is it in fact in a secular decline that results from so profound a change in the regulatory framework of U.S. banks that profits cannot recover, dividends will be perennially circumscribed and, over time, small banks will fade and big ones will be turned into utilities? Not a small question, and your presence here today in Washington shows you know how critical the answer is to each of your banks.

The Complexity-Risk Conundrum

I think the reason many of you despair over federal financial policy is because so much of it pushes and pulls you in totally different directions at the exact same time. That's my definition of complexity risk: too many complicated rules that try to solve every supervisory problem at the same time for all banks under every possible circumstance.

An example: the risk-retention proposal implementing the Dodd-Frank provisions meant to align issuer incentives with those of borrowers and investors. This would apply to banks of all shapes

and sizes if they tried to sell mortgages, auto loans or other paper into the secondary market. I think the law's provisions don't make much sense when taken in concert with many other new requirements – tough new standards governing credit rating agencies and, in fact, an end to reliance on them, along with a ban on no-doc mortgages, an array of new powers for the CFPB in other retail sectors key to securitization, new SEC "transparency" standards, a redefined mortgage servicing model and a lot of stiff new capital and liquidity rules that clamp down hard on securitization.

All the risk-retention rules do, as far as I can tell, is to doom any prudent securitization that might make it through the morass of all the other new rules. This might be acceptable if banks have the portfolio capacity to make credit available once the secondary market shuts down. However, half of all U.S. credit before the crisis depended on the secondary market and, even taking out that which never should have been written, we still need a lot of those loans back in the market. The new capital rules take out the portfolio capacity needed to replace securitization, leaving us with one of complexity risks' most perverse consequences: no secondary market for needed credit availability.

Another acute case of complexity risk is evident in the new framework being crafted for "systemic" BHCs, a term Dodd-Frank defines as any BHC over $50 billion even though I think we'll agree that this asset threshold is well below that at which systemic risk can reasonably be feared. Based on this systemic criterion, the FRB and FDIC are busily writing an array of binding rules and, while I can't fault them for the asset threshold at which the rules apply, I do think many of the proposals are wildly over-complex and, even for the very biggest banks, fraught with internal contradictions that lie at the heart of complexity risk.

Case in point: the 184 new requirements for BHC boards of directors demanded in the FRB's systemic standards. More than a few of these apply also to BHCs with assets above $10 billion, especially when it comes to ensuring that BHC boards have independent risk-management capability. I don't quarrel with the goal – in fact, I think it's vital. But, the details of what BHC boards are to do under the NPR are so over the top that any director dedicated to doing his or her directorial duties as they are about to be defined will need to quit the day job.

One reason for this over-the-top burden is the pile-up of stress-test standards in this rule and several other pending proposals. I count at least nine stress-test standards that govern banks of varying sizes for all sorts of purposes. Surely, there's a simpler way to be sure that stress tests make sense and, then, that directors know what they're learning from the tests even as examiners take rigorous action based on them.

Is Dodd-Frank Repeal the Right Answer?

One cure to complexity risk for which some people hope is flat-out repeal of Dodd-Frank. This, I think, is unlikely for both policy and political reasons.

First, to policy. On the campaign trail, some are calling for simple and complete repeal of Dodd-Frank. But, do we really want OTS resurrected? Do we want to go back to the world in which

there was no option when a big financial institution hit the wall other than a taxpayer rescue? A major improvement included in Dodd-Frank is the end to TBTF. Repeal it and TBTF is back big-time. Do we want a regulatory framework in which only banks are subject to stringent standards? To be sure, FSOC hasn't done much with the new framework Dodd-Frank demands for systemic nonbanks, but at least it's the law and, I hope, soon also the rule.

Now, I know that many of you might like these parts of Dodd-Frank, but tell me that their cost is too high when taken in concert with other parts of the new law: the Volcker Rule, the Section 165 systemic standards and, perhaps, top on your list, the new CFPB. So, from policy to political: much as you hate this stuff and have mobilized powerful allies on these issues, the law isn't going anywhere anytime soon. Even if Republicans take the White House and sweep both the House and Senate in the 2012 election, it's going to take a lot more than that to move legislation on Capitol Hill. Even Republicans in the House haven't really tried to do much of substance about Dodd-Frank in the two years since the law was enacted. So, from a political perspective, the chances of full-bore Dodd-Frank repeal are slim to nil. Even limited revisions face a steep, uphill climb.

Complexity-Risk Mitigation

Given the combination of policy and political factors I've briefly summarized, Dodd-Frank repeal isn't the cure for complexity risk. Quite simply, we can't go back to things as once they were even if things then were all that good – which the crisis has proved they weren't. So, what to do? I recommend a two-pronged complexity-risk cure, and its stiff medicine for policy-makers and bankers.

First, to policy-makers: the heart of complexity risk is an embedded contradiction in Dodd-Frank and, indeed, what regulators are doing even where Dodd-Frank doesn't dictate that they do it. The contradiction is that rules are aimed at fixing everything all at once – promulgating both capital and liquidity rules that are as tough as tough can be despite inherent contradictions in these all-two-complex standards. And, all of these fixes are intended to ensure that no bank can ever fail with taxpayer support even as a set of parallel rules – here's the good part in Dodd-Frank – truly end too big to fail. So, in essence, we are taxing larger banks as if they are utilities even as we yank away the public lifeline. This subjects these firms to market discipline without giving them the resources with which to operate as viable, profitable financial institutions.

And, what should bankers do in the corner office and directors decide in the board room. The policy and political advocacy that brings you to Washington is a critical contribution to redefining the strategic landscape, so I think you all need to do this and more to be sure policy-makers understand the full scope of costs and benefits resulting from the new rulebook. But, the rulebook may not be rewritten as completely or quickly as you want.

From this, I think, comes the biggest challenge of all: investing in the risk-management expertise to develop the array of new products urgently needed to redefine banks in the new financial order. Compliance has become so engrained a caution and capital conservation so great a constraint that most of you are just sitting on your liabilities and hoping no more deposits come

your way. That's no fun and it's surely not very profitable. The new environment offers new opportunities – small banks can "de-commoditize" products like mortgages to keep them on their books, bigger institutions can develop new mid-market corporate products and all banks can do a better job of supporting wealth management, retirement planning and asset management across the consumer spectrum.

The real challenge for bankers is not to protest every rule, just as the urgent task for regulators is not to implement all of the rules all at once. Without balanced recognition that some rules are needed and that others must be scrapped, banking will never right itself, ceding the field to unregulated "shadow" firms that will do little more over time then bring us all back atop a systemic-risk abyss.