Death by a Thousand Cuts:
The Non-Legislative Big-Bank Break-Up

Remarks by

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It's an honor to appear here today on so distinguished a panel. I know everyone here – myself included – has strong views on whether there should be a systemic-risk regulatory framework, what it should be and – most emotional of all – who would get the power. In part because these battles are jurisdictional, they're increasingly passionate. Drama attends this debate also because the Administration plan – for all its far-reaching proposals – doesn't go as far as some want. It doesn't reinstate Glass-Steagall, impose strict size limits or otherwise pry apart the too-big-to-fail banks that have, in fact, just gotten bigger as the crisis progressed. This leads some to suggest that all of the seeds that sowed the crisis are in fact being fertilized for another poisonous crop – a fear that understandably creates strong feelings.

All of these issues are important, especially in light of imminent Congressional action on them. But, whoever gets the systemic-risk gavel will govern a very different industry. Little noticed – but very, very important – decisions are being made now by U.S. and global regulators that will redefine the way big banking organizations make money. Since profits drive strategy – or should – each of these decisions will redefine what pieces go where in which big banks, pushing some of the most controversial activities – proprietary trading as a case in point – out of the bank and, quite likely, out of the organization itself.

The reason Congress needs to act is not to cut big banking organizations down to size. U.S. and global regulators had and have most of the tools they need in hand. New law is required only to ensure the agencies do what they can in the face of stiff industry push-back and – more important – to give them clear authority over bank parents and large non-bank financial-services firms. However, even if the regulators don't get the full sway they want over non-banks, they are taking actions now to curtail the inter-connectedness between banks and large counterparties and reduce large-firm complexity.

What I would like to do this morning is briefly outline what can and – even more important – is being done now to break up systemic risk institutions. The most important caveat here is that many of these actions are being phased in to limit their impact on a highly-stressed industry. If market forces rear their ugly head again – more than possible – bank regulators could go back to the panic-driven actions of late last year, forging huge institutions out of the parts of failed ones because they are too frightened to do anything else. For this reason, legislation is also important and I'll talk today about some often overlooked aspects of the Obama plan designed to ensure regulators do what they say they plan.

But, to what the agencies are doing now. Many doubt regulators are doing anything at all but blessing the big boys, but in fact a lot is under way to break them up. If regulators stick to their plans, they will do a lot to too-big-to-fail banks with or without Congress's help. The most important actions under way are:

- sharp hikes in regulatory capital, especially for the trading book;

- a tough approach to what can be funded with insured deposits and how big exposure to bank counterparties can be;

- new “ring-fencing” rules that sharply limit the ability of international banks to do business through branches; and

- a new understanding of which financial activities are critical “utilities.” New rules are under way to separate utility functions from profit-driven ones, especially in the settlement-and-clearing arena.

There are other critical initiatives under way as well, but let’s focus now on these four drivers to see what they can do – and to whom.

Why Capital Counts

I’ve been a capital geek for years, spending lots of time in the minutiae of these complex rules because they make such a huge competitive difference to clients. Crudely put, profit is return on equity or ROE. If the equity base must double, return is halved – holding everything else steady. Since banks don’t want to see profit halved – let alone drop more because of capital rules – they of course don’t stand still in the face of costly capital requirements. First, they try to beat them back. Failing that, strategies change to reduce or moot the impact of regulatory-capital changes. This is called regulatory arbitrage, and it’s a time-honored tradition at astute financial institutions.

Any doubt about this is settled by a quick look at the debris in the current crisis resulting from adroit regulatory-capital arbitrage. Don’t blame the arbitrageurs, though – they just did what each of them is fully within its rights as a private firm to do. It’s the regulators’ fault for moving far too slowly on even the most obvious failings in the Basel I and Basel II rules.

That, though, was then. What now?

Capital rules may be geeky, but now even the heads of state at the G-20 nations are setting them. The Pittsburgh statement was very, very strong on the need for a far more stringent capital regime. In part, this is because regulators were already building one and wanted their bosses to buttress it. But, now under orders from President Obama and other leaders, regulators will rewrite the rules – and fast. The U.S. is now under a global commitment to come up to Basel II scratch by 2011.

Believe it or not, the U.S. is still under market-risk rules set in 1996 – a clear example if ever there were one of profiting from inaction. As markets got more sophisticated, the capital governing them stayed same-old same-old. Global regulators knew the 1996 regime needed fixing as early as 1999, putting the market-risk rules in play along with the

credit- and operational-risk ones in the Basel II rewrite. In 2005, the Basel market-risk framework was finalized, reflecting many compromises with the industry made in the bliss of the boom. With the bust now upon them, regulators thought better of these trade-offs and rewrote the market-risk rules, finalizing the new set this July.

The new rules are very, very stringent. In fact, they are so tough that regulators stayed their hand pending a quantitative impact study to see just how much the capital regime will cost. This study came out last week and – no surprise – it showed that the trading-book rules will on average double and, in some cases, triple regulatory capital. What is surprising is that the regulators didn't reneg. In the past, when quantitative studies showed sharp capital hikes, regulators retrenched and rewrote. Now, they are fine with the capital hike – fine in part because, knowing ahead of time what the rules do, the G-20 blessed them.

Let's go back to my simple ROE analysis. Double capital, half return. With trading-book capital going up so much – often even more than the average at big trading banks – profit will drop dramatically for proprietary trading and related activities.

This doesn't mean regulators have banned proprietary trading as advocates like Paul Volcker would like. You can keep the business – you just can't make much money at it. That's of course no fun, and I think we'll see many trading activities moved apace out of banks as the scope of the new rules works through strategic planning.

The New Narrow Bank

The second strategic change under way at the regulators deals with what can be done with insured deposits. You are all too familiar with sections 23A and 23B of the Federal Reserve Act, so I won't detail them here. Suffice it to say, as you know, that these rules are critical to determining the value of an insured depository to a holding company and its non-banking activities. Toughen them up, and a bank is just a bank.

And, toughen them up is just what's under way. In its panic, the FRB loosened the rules to permit Goldman Sachs, GM and other non-traditional entities to become BHCs last year. This ticked the FDIC off – and well it should in retrospect. The more risk to which insured deposits may be put, the riskier the banking system and, thus, the FDIC. Tougher standards are already being adopted for troubled firms – CIT is a case in point – but plans are afoot for far more stringent inter-affiliate standards. A read of this section of the Obama legislative draft – little noticed, but very important – shows the scope of change under way to wall off banks from non-bank businesses within a parent company.

Curtailing Counterparties

However, the inter-affiliate rewrite isn't the only major initiative under way to reduce the inter-connectedness of insured depositories with non-traditional activities. Another little-

noticed – but also very important – part of the Obama plan deals with counterparty risk limits. The bill would take the time-honored loan-to-one-borrower limit and apply it to all counterparty exposures involving credit risk.

This is a long overdue wake-up call. Of course, credit risk no longer comes just with traditional loans, it's rife throughout the financial system in a vast array of derivatives structures, funding arrangements and other complex financial instruments. Banks had two, three and even four times their capital at risk with single counterparties in the run-up to the crisis – precisely the reason the regulators were so spooked by the systemic risk confronting them last year.

Now, they plan to deal with it and limit counterparty credit risk exposures – with or without new law. The new law makes it easier, but the agencies don't have to have it to get their way. Securities lending and many other businesses will look a lot different with the new counterparty-risk limits, reducing the hold a very few large banks have over this lucrative business line and others like it. The more banks doing critical financial tasks, the less systemic risk resulting from fragility at one of them and the easier it will be to shut them down, not prop them up.

And, the tougher the counterparty risk limits, the less counterparties can get from single institutions. This doesn't necessarily limit funding for large non-banks – there are lots of institutions out there. But, having to go hat in hand to lots of banks sharply alters the balance of power between private-equity firms, hedge funds and other big-bank customers. This will result in reduced credit and higher cost – just what regulators want to see. They want the old days back, when banks owned their customers, not the other way around.

The Ring Fence

Another little-noticed rule under way addresses ring-fencing – that is, limiting the degree to which a single entity can pose risk throughout a banking organization and the financial system. Along with inter-connectedness, complexity is at the heart of systemic risk and complexity comes in part from opaque organizational structures with intra-group funding commitments and other cross-cutting agreements regulators in home and host countries can't figure out.

FDIC Chairman Bair has recently been big on breaking up offshore branches to force U.S. banks into a simpler, subsidiary-based model. The EU is again also looking at this, as are global regulators at the Basel Committee. In its latest paper on improving cross-border resolution, the panel reluctantly votes for ring-fencing. It knows that this will break up big banks and result in more costly, less efficient organizations. But, it can't think of another way to ensure rapid intervention under stress conditions, and that's what it wants – indeed needs – to do.

The more subsidiaries, the less economies of scale for large cross-border firms. The fewer the economies of scale, the less the profits. The less the profit, the less the desire to engage in offshore non-traditional activities. Again, regulatory incentives will help to break apart complex, diversified, cross-border firms and, with them, systemic risk subsides.

Utility Regulation

Finally, one more little-noticed issue: the treatment of payment-system and other financial activities critical to market infrastructure. The Obama bill has another overlooked section: a new systemic-risk regulatory framework just for clearing-and-settlement institutions. Because this part of the financial system is little understood, it's often overlooked. It is, though, a critical part of franchise value for the very largest banks, especially the one or two in every nation that essentially control these activities.

In the wake of the crisis, several clearing banks have themselves come to recognize how critical they are, like it or not. In the repo area, for example, the FRB is looking at new ways to ensure ongoing clearing under stress situations. An idea under active consideration goes beyond the new regulatory regime to creation of actual utilities which the FRB would control. Time today doesn't permit a discussion of these ideas and the prospects for these firms, but they're also a very important part of the systemic-risk solution already well under way under current law. If critical infrastructure is taken over by utilities – either government owned or private sector – the financial system will have been dramatically redefined with barely a peep from Congress.

Conclusion

I said at the start that, like everyone here today, I do have strongly-held views about the new systemic-risk regulatory framework and who should run it. The battle lines are of course drawn between the Fed and FDIC, with the functional regulators weighing in to ensure a role for themselves as well. To add a bit of my own passion to the heated debate, let me say that not one of these agencies has anything to brag about. There's nothing that's happened to banks, the financial system and all the rest of us that needed to happen. Much of what led to the crisis was seen clearly down in the supervisory trenches and, often, at the lower levels of corporate risk management not allowed to speak truth to power.

The biggest fear I have is that whoever gets the systemic-risk gavel will quickly be captured by its charges. No matter what Congress does, this can easily happen, especially if regulators spook in the face of new challenges and continue to construct ever bigger financial-services firms with ever wider taxpayer guarantees. If regulators press forward on the initiatives now under way to deconstruct too big to fail, the chances of a recaptured regulatory system will diminish.

However, one important caveat: to the degree the new rules apply only to banking organizations, big banks will rightly argue that the chances for regulatory arbitrage will re-emerge once the coast is clear. That's why new law is essential. But, even without it, regulators should quickly advance many of the initiatives quietly under way now under current law. The new discipline will ensure far less systemic risk because it will be far harder to make out-size profits through sheer size alone.