Regulators Have Leared Nothing From The Financial Crisis

YOUR TAXES, YOUR MONEY: COMMENTARY—BANKING REFORM
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In marketing **Basel II** to policymakers and the general public, bank regulators described the then proposal as "a three legged stool"—offering a vision of stability where the financial system would be supported by three pillars.

Those pillars were minimum capital standards, an improved supervisory review process and increased market discipline. The financial crisis revealed serious faults in all three pillars.

Market discipline was jettisoned first. In fact there is probably no characteristic that defines the **recent financial crisis** and the government response to it than a rejection of market discipline. Companies could not be allowed to fail; creditors could not take losses.

The fundamental flaw of this third pillar was that it lacked an enforcement mechanism. Disclosure of risk is meaningless if market participants come to believe they will be protected from that risk by government. Nothing in either Basel II or III establishes a mechanism where creditors know with certainty that they will take losses. The "resolution" mechanism in the **Dodd-Frank Act** has so many holes as to lack any creditability.

In fact both the Dodd-Frank Act and bank regulators have made it very clear that creditors will be protected. For instance, Dodd-Frank codifies the **FDIC's** guarantee of bank non-deposit debt. The **Federal Reserve's 13-3** powers remain largely untouched. There is no reason for creditors today to expect anything other than being bailed out.

If creditors were a small part of our financial markets, then perhaps their protection would only present minimal distortions. Yet even under Basel III, creditors will still be over 90 percent of the funding for the typical financial institution. To insulate the vast majority of funding from any market discipline is to invite financial crises.

Recently attention has focused almost exclusively on the first pillar: increased capital. Unfortunately this pillar is as damaged as the third. The increased capital requirements under **Basel III** are still nowhere near what the market would demand on its own.

When the next panic hits, market participants will again ignore "regulatory capital" and focus on common equity. We would be better off abandoning the facade of minimum capital standards and let the market decide. It is hard to see the market demanding any less than what Basel III requires.

The first pillar of capital standards is also flawed in its management of relative risk weights. The favoring, if not actual subsidizing, of sovereign and **mortgage debt** not only remains, but is expanded, under Basel III.

It is no coincidence that these are also the markets that have suffered the most disruptions and required the largest bailouts. Any framework that treats debt issued by entities such as **Fannie Mae** and **Greece** as essentially risk-free is a framework that cannot be taken seriously. The current risk-weighting, along with increased liquidity requirements, further insulates both governments and the **mortgage market** from much needed market discipline.

The second pillar, supervisory review, has revealed itself as fatally unsound. It would be an understatement to say the world's bank regulators were asleep at the wheel. Yet **bank regulators** appear, for the moment, to have awoken from their slumber.

It remains to be seen whether their attentiveness will last, particularly when the public and politicians demand that the next bubble be allowed to grow. We could greatly improve supervision if regulators themselves were subjected to accountability, by say, losing their jobs when the institutions under their care fail.

The Basel III process so far has indicated that bank regulators have learned almost nothing from the crisis. Many of the contributors to the crisis, including Basel II, are being expanded instead of being scrapped. At least this time around we'll know that the stool we're being asked to sit on doesn't have any legs.

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