Dealscape

Poole's market solution for bank regulation

SHARE E-MAIL RETURN TO FULL STORY

Published May 21, 2009 at 11:53 AM

WILLIAM POOLE

Is the Financial Times the only major newspaper to actually care seriously about financial regulation? For the past six months, the paper has regularly opened its columns to a variety of voices (sane, insane, defensive, bombastic, belligerent) arguing various aspects of the regulatory response to the crisis. On Thursday, former St. Louis Federal Reserve chief executive and current Cato Institute senior fellow William Poole presents, no surprise, a market mechanism for dealing with the problem of banks that are too big to fail.

Poole is certainly sane. He offers a solution that involves banks taking on 10-year subordinated notes equal to 10% of its liabilities. The sub debt would be above and beyond the usual capital requirements and provide a further cushion. Moreover, Poole argues, the fact that every year the bank would have to roll over debt equal to 1% of its liabilities would force it to run operations in a way that would comfort a class of unsecured creditors who would be among the first to get wiped out in the event of disaster. If the bank can't roll over the debt, the bank will have to run off 10% of its liabilities, thus shrinking back to safety.

As Poole admits, bankers will hate this idea, because sub debt is relatively expensive and will weigh upon them, in good and bad times. And the problem with this class of market mechanistic solutions, like a gold standard, is its rigidity and inflexibility in a fast-changing world. That said, the best argument for it is that it offers some relief from the chronic problem of regulatory capture, or simply a failure by regulators to recognize a credit bubble. As Poole confesses, "Ahead of the crisis, regulators, myself included, did not understand the risks of subprime mortgage paper in bank portfolios." Poole may be overoptimistic that the sub debt market is any more immune from the seductions of a bubble than regulators.

Thinking about this notion, however, raises larger contextual issues about bank regulation that, in the current anti-bank climate, get overlooked. Poole does not define a "bank," assuming presumably that institutions classified as bank holding companies would fall under these rules. For these institutions -- and you do have to wonder how long Morgan Stanley (NYSE:MS) and Goldman, Sachs & Co. (NYSE:GS) would remain bank holding companies under strictures like this -- a sizeable, and extra slug of sub debt will weigh heavily, like a racehorse carrying 20 extra pounds. This may be what's required for safety, but, as with a variety of other proposed measures to boost capital and limit operations, commercial banks will increasingly be at a market disadvantage, not only to nonbanks but to foreign rivals that may not share the same constraints.

What does this sound like? This resembles the great "disintermediation" flap of the 1980s and early 1990s in which highly regulated commercial banks, just beginning to escape local and state constraints to expansion, found their role as intermediaries shifting to lightly regulated, nonbank competitors, from Wall Street firms to money managers to nonbank banks. Bank margins were squeezed and share prices fell, just as equities were becoming the sole standard of success or failure, most famously in terms of compensation. Now we seem to be returning to that earlier situation (although many smaller and medium-sized banks never escaped it). Most of the strategies the banks used to successfully battle against disintermediation -- a lovely word for cocktail parties -- may well be, and arguably should be, constrained or eliminated: pell-mell expansion and consolidation; diversification into market operations, including principal investing; significant extension of capital through shadow banking.

The question raised by Poole's notion of a sub debt market mechanism is really: What about the rest of

the market? Like a gold standard, the sub debt mechanism will act as a governor on bank growth and profitability. Banks will have to squeeze out profits from traditional commoditized profit centers -- retail banking, credit cards, corporate lending, bank services -- and perhaps some advisory or brokerage work. But the former will feature thin margins and the latter intense competition from unconstrained nonbank rivals. This is not a recipe for success. And it points out once more how the popular notion of "utility" banks will produce a sleepy, low-growth sector that grows increasingly irrelevant and that may eventually prove to be an economic drag; think the old AT&T. The ultimate danger to such a sector, beyond its lack of competitiveness globally, is what occurred in the S&L crisis: In order to escape structural unprofitability, the S&Ls, abetted by Congress, bet the moon in a variety of ways and crashed and burned.

The bottom line: Poole's market mechanism is an interesting idea, but a systemic scheme, and perhaps a systemic regulator, is still required. Partial regulation is a recipe for disaster. There's simply no escape from the difficult tradeoffs and challenges of intelligent human regulation. - *Robert Teitelman*

Robert Teitelman is the editor in chief of The Deal.

SHARE E-MAIL RETURN TO FULL STORY