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REMEMBERING THE FUTURE

Volume V, Issue VI, March 2015

Imagining the Future of Finance: The Tides of Rising Fragility

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Introduction

Last month Mark Carney of the Bank of England warned of "reform fatigue" in the G20 during a discussion about the state of the global financial system. His remarks are accurate and should disappoint anyone concerned with reducing risking in the global economy. Restructuring the plumbing of the financial system since the onset of the Financial Crisis has been an arduous process, with patchwork rules being written about what banks can and cannot do. Rather than addressing the bedrock structure of the financial world, the changes offered since 2008 are a piecemeal approach that shift risks rather than eliminate them, which keeps threats of contagion intact. Short-staffed regulators are playing a game of catch-up to the practices of financial engineers as opposed to addressing the way business is done.

Two ideas that have garnered attention either in academic circles or in public policy discussions over the past several years seek to change the very wiring of U.S. financial markets: Asset-Based Reserve Requirements (ABRRs) and the better publicized capital regulations that have come out of Basel.

By examining these various proposals, each with their own strengths and weaknesses, and combining them with our view of markets we can collect central themes highlighting the current fault lines in finance and how to rethink the sector's regulations.

Asset-Based Reserve Requirements

ABRRs are a lesser-known policy proposal put forth by Thomas Palley, a senior adviser to the AFL-CIO, who has been writing about the fragility of the current financial architecture for over fifteen years. Palley points to the increasing complexity of the financial system as blunting the efficacy of monetary policy. With innovations such as securitization, collateralization, and the breakdown of the Glass-Steagall regulatory system, financial markets underwent a revolution (Figure 1). The following table demonstrates the shift in households' holdings.

Figure 1: Balance Sheet Shifts, Thomas Palley

Type of holding	1979	1999
Deposits	25%	10%
Life Insurance Reserves	4%	2%
Pension fund Reserves	14%	30%
Mutual Fund Shares	1%	11%
Corporate Equities	13%	23%
Equity in Non-corporate Businesses	30%	13%
Bonds & Notes	8%	6%
Other*	5%	5%

Source: Financial Markets Center, Philomont, VA, based on Federal Reserve Flow of Funds Data, cited in Palley (2000).
*Includes Security credit. Bank personal trusts and miscellaneous.

One of the most important data points from Palley's table is the percentage of household assets made up of deposits. Though a bit dated the figure still holds according to our research as deposits made up 11% of household claims through the third quarter of 2014 according to the Federal Reserve's Flow of Funds report. Depository institutions have swept deposits into money-market accounts, which are not subject to reserve requirements. With this transformation the potency of Fed action is diluted as its policy levers control a smaller part of the financial system.

Palley's proposal then is to refocus monetary policy by targeting asset classes instead of institutions. Specifically, institutions owning financial assets would also have to hold reserves in an account with the Federal Reserve in proportion to their level of assets owned as determined by the central bank. Palley's ABRR proposal would also segment required reserves by each asset type as well, meaning that some assets held by financial institutions would require a greater quantity of reserves than other classes. The purpose of such a segmented system is to give regulators the ability to target specific markets that could be contributing to financial stability as opposed to using a blunt instrument, like interest rates, that would ripple through the entire Macroeconomy.

To use an example, imagine the Fed sees real estate markets as developing bubble symptoms, but there is no evidence of similar bubbles elsewhere. To stave off the bubble using its present tools the central bank would have to raise interest rates affecting all other asset classes concurrently. Under a system of ABRR the Fed could raise the required reserves for holding real estate assets, thereby tightening conditions for that market and leaving other markets unscathed. The hope is that ABRR can be a way to prevent episodes of excessive credit creation.

Palley also touts the self-stabilizing nature of ABRR, something that capital regulations do not offer he argues. When new assets are created or appreciate the financial sector must accumulate additional reserves and when assets fall in price (or fail completely) reserves are freed up creating an automatic easing mechanism. He also touts micro advantages in which case reserves can be lowered for efforts deemed to be in the public interest. Renewable energy or infrastructure projects, for example, could be incentivized through this system by lowering reserve requirements relative to all other asset types.

As for its feasibility Palley's model does have some precedence. State regulators in the U.S. frequently require insurance companies to hold a required level of reserves against their assets and do so in a more detailed manner than other financial institutions.

Asset-Based Capital Requirements

Asset-Based Capital Requirements (ABCR) have a similar intent as ABBR, but instead of overhauling the modern monetary system capital regulations, they seek to end patterns of excessive credit creation and debt dependence by addressing the inadequate levels of capital that banks use to finance their activities. In their stellar book *The Bankers' New Clothes* Anat Admati and Martin Hellwig consolidate research and analysis that puts the capitalization mix of banks front and center and offer the most powerful defense of this system.

The central tenant of ABCRs is to mandate that banks finance their businesses with greater amounts of equity in their capital mix. Much like a homeowner is better able to avoid bankruptcy if the home's value depreciates with a greater down payment, banks are able to withstand the fluctuations in asset prices by funding their business with a greater proportion of equity. Liquidity crises can turn into solvency crises if not addressed, but the seed of liquidity tremors often originate from an initial questioning of the ability for the borrow to repay debts; the greater the levels of debt the greater the sensitivity to even

the smallest of shocks. Therefore, mandating a greater proportion of equity in banks' capital mix therefore reduces the debt addiction that plagues the financial sector and makes the economy as a whole safer.

A greater use of equity to raise capital also has profound repercussions on corporate governance. Today, perverse incentives exist for companies to prefer debt to equity, increasing risk in the system. Interest payments are tax deductible, managerial compensation incentivizes lower levels of equity and acquiring greater levels of debt in order to make bigger bets beholden the financial system in its entirety to a firm's individual survival, the problem known as Too Big To Fail. Mandating that banks utilize greater levels of equity to fund asset acquisition disciplines managers and their wild risk-taking attitude while also incentivizing shareholders to closely monitor the risks bankers take with their capital.

To no ones surprise bankers have greeted the logic of higher capital requirements with millions of dollars in lobbying efforts and humorous rhetoric, chief among them that the cost of equity is too high to warrant issuing more of it, as it would damage their profitability. Aside from the fact that increasing capital levels can be done by retaining earnings as well as issuing new shares, they conveniently overlook the capital levels of competing industries (Figure 2).

The data makes a mockery of arguments utilized against capital requirements. The table clearly demonstrates that healthier capital levels had no bearing on a firm's ability to grow, nor did it have any detriment on an ability to generate greater returns.

In a pure theoretical sense equity is more expensive than debt because the former has the lowest claims to a company's income streams. However that is an incomplete way to evaluate required returns according to Admati and Hellwig.

Figure 2: Capitalization and Profitability: Banks vs. Non-Banks, Federal Reserve and FinViz

Top 10 Banks By Assets

Company	Market Capitalization (Billions)	Debt/Equity Ratio	Return on Investment
JP Morgan	231	1.31	6.60%
Bank of America	168.31	1.08	7.60%
Citigroup	162.49	1.12	8.10%
Wells Fargo	282.55	1.11	9.10%
Goldman Sachs	82.8	4.32	2.20%
Morgan Stanley	69.3	4.34	1.80%
US Bancorp	79.62	0.83	10.50%
BNY Mellon	44.76	0.56	3.20%
PNC	48.4	0.62	9.40%
Capital One	43.51	0.67	16.10%

Top 10 Non-Financials in S&P 500

Company	Market Capitalization (Billions)	Debt/Equity Ratio	Return on Investment
Apple	736.31	0.30	26.20%
Exxon Mobil	363.85	0.12	17.10%
Microsoft	353.67	0.31	19.50%
Johnson & Johnson	285.06	0.27	18.40%
Procter & Gamble	228.54	0.55	11.70%
Pfizer	217.18	0.48	8.70%
Verizon	199.22	9.21	13.00%
Chevron	196.91	0.18	6.40%
AT&T	176.47	0.95	4.90%
Facebook	227.31	0.01	8.30%

Returns to equity must be viewed in the total capitalization mix as opposed to isolation. Using lower levels of equity to make investments concurrently raises the required return of equity holders, pushing managers to take greater risks, leading to the misallocation of capital. Thus increasing the equity level reduces its "expensive" nature while also making the firm more resilient.

Regulators have tried to address capitalization concerns in the aftermath of the crisis. The Basel accords agreed to in 2011 mandated higher capital levels on a global scale and the Fed has superseded the rules on multiple occasions,

demanding that specific large banks operating in the U.S. have capital levels exceeding the 4.5% of Risk-Weighted Assets agreed to in Basel, as well as comply with other rules stipulated by the central bank.

Reserve Requirements vs. Capital Requirements: A Brief Comparison

ABRRs offer an umbrella approach to the financial sector that the Basel reforms lack. Instead of zeroing in on the banking industry the reforms offered by Palley would touch a greater number of parties, as its approach is asset based as opposed to institution centric. As a result, it covers the vast array of firms that have evolved over the past few decades to become major financial players, such as shadow banking.

Shadow banking activity will maintain a growing presence in markets going forward, the longer long-term returns are expected to remain low. In a recent Bloomberg radio interview Cliff Asness of AQR Capital Management, a giant in the world of finance, presented his estimates that the 10-year real outlook for returns on the standard 60/40 portfolio (60% stocks/40% bonds) was considerably below average at 2.5%. With returns so low the mismatch between present funds and future liabilities grows as Ron Ryan, a pension consultant, recently explained to Barron's; Either investors have to put up greater funds today to reach a targeted value in the future or take greater risks. Shadow banks offer access to both high-risk high-return assets and also control a greater percentage of funds. The IMF found that the biggest driver of the shadow banking system since 1990 came from the demand of institutional investors, the very organizations facing the mismatch between present assets and future liabilities (Figures 3 and 4).

Palley's proposal is also appealing as it is an asset-specific approach to monetary regulation. Unlike the blunt tool of interest rate changes, regulators and central bankers can pull policy levers targeting specific asset classes, while protecting other sectors from additional burdens.

Figure 3: The Drivers of Shadow Banking, IMF

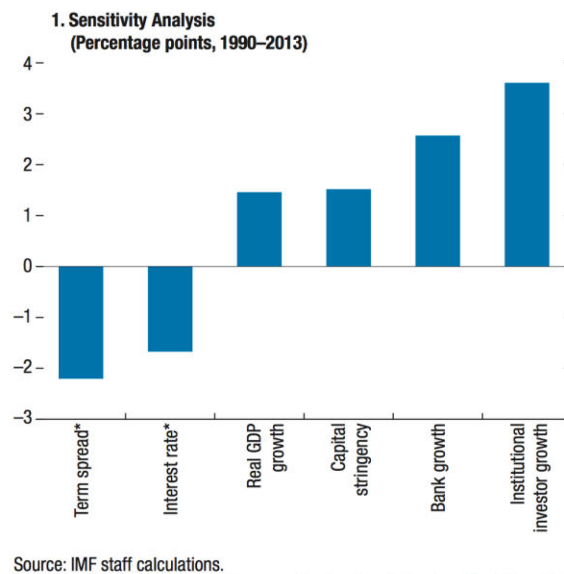
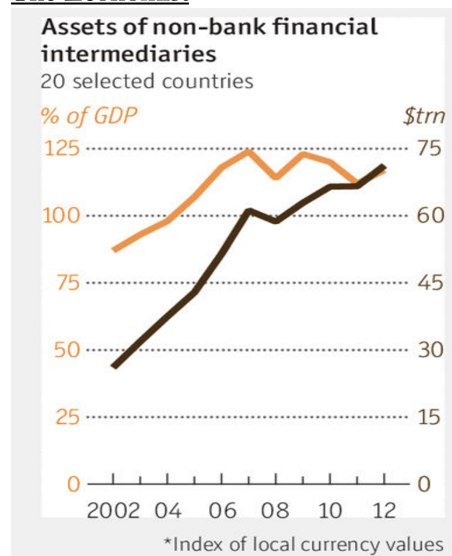


Figure 4: Shadow Banking's Growing Presence, The Economist



The approach offered by ABRR is not without its own holes, some quite concerning. First, assigning reserve ratios per asset class is dependent upon

regulators being able to properly assess which assets are risky and which are not. If they had this capability they surely did not demonstrate in the lead up to the credit bubble last decade. The engineers on Wall Street are quite adept at passing off something as safe. Second, can a system of ABRRs work in a market flooded with excess reserves and a central bank on a standby mode to create them at will, bailing out any financial institution it deems fit? While other concerns exist, these two are the most glaring and concerning. The fact is that ABRRs do not provide a check against the incentives pushing firms towards debt and could create a world where the central bank's balance sheet stays large forever. Rather, ABRRs hope that by financial institutions holding cash in reserve the system will be safer.

Capital requirements, by contrast, provide the cap on credit growth to more sustainable levels in theory. The Basel framework however has not implemented the theory in full in two key ways. First, the capital standards agreed to two years ago are woefully low and also stipulate the use of risk-weightings, meaning that banks can discount the value of their assets since some assets are safer than others, changing their capital needs. Charles Goodhart, formerly of the Bank of England, has voiced concern that banks are gaming the rules with their models, while studies have suggested a variance of up to 20% in terms of the capital needs of banks due to the implementation of risk-weightings.

Second, additional layers of capital requirements have been dependent on hybrid instruments (debt that converts to equity) in the hope that these investors will allow for losses to commence without a bailout. The record is not convincing with these instruments however; Governments supported hybrid capital holders in the bailouts during the crisis fearing domino effects if these assets collapsed. These instruments would also increase volatility around the price point where conversion takes place and still do not offer as much safety as common equity capital. The Basel accords would be better off without the distortions that risk-weights and convertible debt create, and even stronger if the capital levels were far higher than 4.5%. As Ms. Admati preaches: "we need another digit."

Despite the allure of safer banks and less contagion that higher capital levels promise there are concerns. First, as Mr. Palley points out, capital requirements are a procyclical element; as the value of equity rises financial institutions can grow their assets automatically and vice versa. This poses the threat of volatile asset markets, where banks have to sell assets on their books since the value of their equity has fallen but those very asset sales may propagate further erosion in equity, generating a cycle of asset sales. Banks in fact have often announced the sale of current assets (such as loans) to comply with the Basel rules instead of raising new equity or retaining earnings. Second, the accord out of Basel pertains only to banks while a growing amount of intermediation is occurring outside the banking sector. Higher capital levels would further propel a shift to non-bank financial intermediation. By lowering the ability or willingness for banks to create credit a new market opportunity is opened up for other players outside the jurisdiction of regulators.

<u>Conclusion</u>

Paul Romer, the well-known economist, once joked "a crisis is a terrible thing to waste." The defining financial crisis in generations has left us with bigger banks, an incomplete regulatory bill recently diluted with the aid of lobbyists, and marginally greater levels of capital, while the global economy continues to struggle in expanding, and hundreds of trillions in derivatives remain backed by little, if any, substance. Much still needs to be done to safeguard financial markets.

The incremental steps taken may reflect a better system than the one prior to the crisis but that was not a high bar to get over. Two large themes emerge from our review. First, a preventative measure is needed to combat credit expansion, not just a tool to rely upon if/when things go bad. We have ample evidence from history in the U.S. and elsewhere that excessive credit extension is synonymous with financial troubles. Second, finance has evolved in the types of institutions involved and the services/products offered. With quantitative evidence suggesting returns will be below normal, innovations will only be spurred further; financial institutions will attempt to turn to private markets where higher returns are offered and present them in a liquid form to satisfy the yield demanded by investors. Thus, the definition of the financial system will continue to expand to a greater number of players.

Analysts and regulators have been too quick to celebrate the changes thus far and proclaim an era of safe banks. Capital levels are still razor thin in the financial world compared to other industries while expansive monetary policy, rather than fundamentals, has cushioned the blow from the crisis. Regulation in general is still targeting a narrow audience as items such as off-balance sheet instruments have not been addressed. As Ms. Admati was quoted in Davos we are still "shooting ourselves in the foot creating a fragile system." In other words, Mr. Romer's joke may be on us.