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REQUIRING BANKS TO HOLD MORE CAPITAL:

BENEFITS AND COSTS

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WESSEL: [00:03:58] Good morning. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy here at the Brookings Institution. Today, we're going to talk about something that is economically important but that many people haven't taken the time or have the patience to understand. How much capital should big banks be required to have? Regulators -- the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation -- have a proposed to increase the minimum required capital. To better compensate, they say, for the risks assumed by the 37 biggest banks in the U.S. who represent the bulk of the US banking industry's assets. This is the final stage in Basel III standards set after the Global Financial Crisis. Hence the name “the Basel III end game.”

Now the banks say this is overkill and will starve the economy for credit. And they've been mounting an aggressive lobbying and advertising campaign to pressure the regulators to back off a bit. And I expect we'll hear from bank chief executives tomorrow at the Senate Banking Committee on that subject. Now, there are tradeoffs to be made here. How much insurance do we want to force banks to have to protect the rest of us from financial crises? What are the benefits to the overall economy and what are the costs? I'm pretty sure we're not going to resolve those questions today, but our hope is to shed some light on them, because so far much of the conversation has been an argument among people who make a living understanding the details of bank capital regulation, which is a pretty small fraction of the population. I'm hoping to bring the rest of us into the conversation today. I recently took a stab at explaining what's going on in an explainer we've posted on the Brookings.edu website (https://www.brookings.edu/articles/what-is-bank-capital-what-is-the-basel-iii-endgame/), but today we've invited four experts. All of them have strong views on these questions.

Let me just introduce them in alphabetical order: Anat Admati is the George G.C. Parker Professor of Finance and Economics at Stanford Graduate School of Business. Among other things, she's the author of a book called "The Bankers New Clothes: What's Wrong With Banking and What to Do About It?" So you can kind of tell where she's coming from. An expanded version of that book comes out in January. Greg Baer is president and chief executive of the Bank Policy Institute. That's a public policy research and advocacy group representing the nation's leading banks. So you can tell where he's coming from. Greg is a lawyer. He's worked at JP Morgan, Bank of America, Wilmer Cutler, the U.S. Treasury and the Federal Reserve Board of Governors. Steve Cecchetti is the Rosen Family Chair in international finance at the Brandeis International Business School. He spent five years earlier as head of monetary and economic department at the Bank for International Settlements. He and his colleague Kim Schoenholtz are authors of a money and banking textbook and a blog that bears that name. He happens to be a nonresident senior fellow with the Hutchins Center at Brookings. And Jason Goldberg is managing director at Barclays, where he's been for 15 years. He's now the senior research analyst covering large cap banks. He previously did similar roles at Lehman Brothers and at Citi. So welcome to all of you. If you have questions, you can put them you can email them at events at Brookings.edu, or on Twitter, hashtag bank capital. And I thought we'd start first by Steve by asking you and then I'll turn to Greg. What exactly is bank capital? What is its purpose and why do we. What's the role of regulation in setting the amount of capital that banks have to have?

CECCHETTI: [00:07:38] So thanks very much, David, and thank you for inviting me to be with this very distinguished group to discuss, I think, what is an incredibly important question today. So at it's very simplest level, capital is the net worth of the bank. It's the

shareholders stake in the bank. It's the difference between assets and liabilities. And importantly, it's a liability concept. It's a source of funding for the bank. So it's being used to purchase assets. It's being used to purchase cash, make loans, purchase securities and the like. And it serves, I think, several important purposes. The first one is that it acts as a buffer that separates the bank from insolvency. So if the bank takes losses on its loans or on its securities portfolio, the first loss will go to the to the bank's owners, to the equity holders who are providing this this bank capital to the bank. in that protects the depositors as well as the bondholders. Importantly, of course, as is implied, I think, in what I just said, bank capital is not in any sense idle. It is in use. And it's important to understand that it's a source of funding. The second thing is that it acts as a form of self insurance to improve incentives and to improve the incentives of bankers. If we can think of the bankers and the banks' owners as effectively having a put option, that is to say that they have an option where they get the upside and if they go and become insolvent, the resolution authority in the case of the U.S., that's the FDIC and the public, would end up with the bank. So the limited liability that the bank's owners have means that their loss is limited by their initial investment. The smaller that investment is, the more leveraged the bank is, the lower its capital funding level is, the more the owners and the capital providers are going to benefit from the upside and the less that they're going to lose on the downside. So the point is then the higher capital improves the incentives of the banks, owners and managers to properly manage risk. Now, importantly, to get back to your original question about capital, it is important to keep in mind that it is difficult to measure capital. We're going to come back to this, I suspect, at various points. But because assets of a bank can be composed of say, things are varied that are extremely difficult to value, some things could be quite illiquid and hard to value as well as things that are intangible. And here examples are things like these are strange accounting items that not everyone will surely understand or need to understand, but things called goodwill or deferred tax assets or the like. Those things make it very difficult to actually compute the level of capital. So I would say that the degree when we think about the size of the capital and the level of capital requirements that we want, we want to think about those three things. We want to think about the size of the buffer, how big we want the losses to be, what the incentives are for the for the bank person, how we might want to improve those incentives for them to manage risk well, and finally, the difficulties that we might have in measurement and how those difficulties might affect the level of capital that we ask the banks to have.

WESSEL: [00:11:20] Greg, how does it look to the banks?

BAER: [00:11:22]I thought that was a great description by Steve, and I think I'll just build on that and move from what's capital to what's capital regulation and then what's this new Basel proposal. So, , capital regulation is expressed generally in required ratios. It's not going to be that complicated, I promise. So if you have an 8% capital requirement, that's 8% of what is what. The 8% is the numerator, is how much capital you have. Used to be complex, but now it's basically common equity Tier 1 or what you think of as common stock and the denominator is your assets. So if you have $100 in assets and $8 in capital, your ratio… you've met your 8% ratio. The complexity comes with how do you think about those assets? You can treat all of those assets the same and just add them all up. But at that point, you're effectively saying you're going to require the same $8 against both a subprime loan and a Treasury security. And that doesn't actually make a lot of sense intuitively. And also, it gives banks an incentive to hold riskier assets because they can earn a higher return on that capital. So the basic notion has been for some time that we want to have what's called risk-based capital standards, and we want to do what's called risk weighting the assets. So instead of treating them all the same, we will treat them differently based on the probability that they'll be a default. And then the loss given that

default. That's what the Basel proposal is all about. And it's but it's basically saying or trying to do is to make the system a little more risk sensitive than it has been. So we know traditionally 100% risk rate means you hold the full $8 or 50% risk weight means you hold $4. And that's kind of where mortgages work. So the new proposal actually doesn't treat all mortgages as the same. It looks at the loan to value ratio and it gives you a different charge based on what's going on there. That becomes incredibly complex and is very difficult to do. If you are too broad in your applications, you come up with sort of dumb outcomes like we're going to treat a subprime mortgage the same as a prime mortgage. But if you get too far into the details then effectively you're doing credit allocation. So it's important to know in capital regulation, there's no right answer. It's impossible to satisfy everyone because you get allocating credit or you're acting stupidly. But the thousand pages of that proposal is really about trying to make a series of choices about different assets and how much risk they hold. To give you one, just in the weeds example, it's not just loans and other assets, it's even off balance sheet items. I think Steve mentioned this. So one that's been controversial is how much capital do you hold against an unused line on a credit card? So if you have a $10,000 line and you've used $1,000, should the bank hold capital against $9,000 even though you haven't barrowed that money from the bank? Well, the answer is, well, yeah, sure. The proposal actually proposes to double the amount. I won't get into the detail. It's 5 to 10%. But that has a real consequence, which is banks are saying if that happens, we're going to cut lines. That has consequences because there are a lot of people who use those lines as sort of an emergency source of credit as opposed to going to a payday lender or something. So it's a just an example of how a tiny little credit allocation decision and thousands of pages can have real world consequences and sort of a lesson just in how this proposal actually has real consequences for real people.

WESSEL: [00:14:47] Okay. We'll get to some of those things. But Anat let me ask you. So do banks, in your view, have enough capital? And what are the pros and cons of a proposal which like this one which is pending, that requires the bank to hope that many banks have more capital?

ADMATI: [00:15:13] Thank you for having me here. I've been in this debate for over 13 years, and the start of it was a paper by four of us that was called "Fallacies, Irrelevant Facts, and Myths in the D Discussion of Capital Regulations: Why Bank Equity is Not Socially Expensive.(https://www.gsb.stanford.edu/faculty-research/working-papers/fallacies-irrelevant-facts-myths-discussion-capital-regulation-why)
So then shortly after we wrote this paper, 20 academics wrote a short letter at the signing of Basel III back in November of 13 years ago (https://www.gsb.stanford.edu/healthy-banking-system-goal), saying that the proposal is entirely inadequate. Basel III is far from sufficient. And we say specifically a few things that are relevant for this debate. If a much larger fraction, at least 15% of banks total non-risk weighted assets were funded with equity, the social benefits would be substantial and the social costs would be minimal, if any. And then we debunk a bunch of claims in a very short letter. We were constrained by the fact that the CEO of Citi had to publish an op ed the next day saying some of the same policies you write of, in fact, omit something about the return on equity, which I just recently gave to my undergrads at Stanford to debunk. And then specifically on the risk weights, what we say: " The Basel Accords determine required equity levels through a system of risk weights. This system encourages 'innovations' to economize on equity, which undermine capital regulation and often add to systemic risk. The proliferation of synthetic AAA securities before the crisis is an example." There is much evidence of that. And in fact, what we see right now is essentially a weaponization of this complexity of the

regulations, including what Mr. Baer was referring to, the sort of attempt to micro calibrate these things and thus affect the banks' incentives. And so we also say on lending specifically: Bankers warn that increased equity requirements would restrict lending and impede growth. These warnings are misplaced. First, it is easier for better-capitalized banks, with fewer prior debt commitments hanging over them, to raise funds for new loans. Second, removing biases created by the current risk-weighting system that favor marketable securities would increase banks' incentives to fund traditional loans. Third, the recent subprime-mortgage experience shows that some lending can be bad for welfare and growth. Lending decisions would be improved by higher and more appropriate equity requirements." Now, in the book that was mentioned, which I just yesterday got the second edition, which is 200 pages long. So it's not as long as it's not as long as the capital requirements and only half of it is in text and the rest in notes, we argue strongly for a measure of for equity levels that are actually not so finely tuned, calibrated to begin with, meaning to keep them between some numbers that I'll be thrown out of the room for saying 20 to 30%, aim for 30, let it go down to 20, intervening time way ahead of insolvency. Now, I should say this is about solvency. The measure is not even a balance sheet measure. We meet the market value of the assets, not the accounting value and not the risk weighted assets. We need the actual market value of the assets relative to the actual face value, actual liability.

ADMATI: [00:18:45] To measure insolvency and let me say I come I come from an area in from the world of corporate finance where corporations fund with a lot of equity and they despite no regulation on it, there's nothing different about equity markets for banks and non banks. If their stock markets go down, if they don't like it, that might just suggest to us that their business model is too much dependent on subsidies.

WESSEL: [00:19:08] Okay. So let me I want to make sure I understand. I think you made a couple of points. One is you don't like all the things t, including the one that Greg referred to, where they try and turn the dials on different risks because you think that that may just have unintended consequences. leading the banks to do things that might be just to satisfy the regs, not to add to what's good business or good innovation. But in general, you think that banks should have a lot more capital?

ADMATI: Yes.

WESSEL: And you think you referred a couple of times to that social benefit. And by that I assume you mean if I'm a banker, I'm my primary concern is my returns. That's my job. And you're suggesting in suggesting that the society may want them to hold more, have more, capital than that in order to protect us

ADMATI: [00:20:01] Returns are not we teach students to do the net present value return is a function of leverage. And that's been, Nobel Prizes were given for understanding that, when you have less required return and stock markets price the risk every day for every company.

WESSEL: [00:20:18] All right. So, Jason, let me turn to you. If I'm a stock market investor, if I'm buying shares in banks. Do I care about how much capital theyhave and just if they have more capital, does that make me pay less for the bank share or what? Jason.

GOLDBERG: [00:20:43] Yeah. No, , good question. And we've heard, a lot so far. And, Steven gave a definition of capital. And then one thing that's important is, there's only two

places that banks get capital from is, one, the retained earnings and the higher the ROE, the quicker they read, the more earnings they have the ability to retain

WESSEL: ROE is the return on equity or profit.

GOLDBERG: Secondly, from investors. So it's important for banks to have the ability to, , access the markets. If you think about, ROE, if a bank has a 17% ROE today and, it's risk weighted assets goes up by 20%, which is kind of what we estimate the proposal will be that ROE goes from 17% to 14%. And the correlation between a bank's ROE and its price to book multiple, which it trades at is,0.9--high. So, the market is, I think, very much focused on the returns that banks, banks do provide. So there is I think a couple of indications of the rule is right. It does increase our risk weighted assets banks have. And, really nothing has changed in the ratings of the bank between today and prior to this proposal. And in fact, under the last Fed regime, they are pretty clear that this Basel III end game wouldn't increase capital requirements. And in fact, this proposal absolutely does as is. And then secondly, for the regional banks, their capital goes down because all of a sudden now they're going to have to include certain aspects of AOCI, which you haven't talked about. But, previous --

WESSEL: [00:22:28] I'm, I'm trying to keep this as acronym free as possible is what you're saying.

GOLDBERG: [00:22:34] Banks have lower capital as a result of some of that --

WESSEL: [00:22:36] Because the banks now, some of the things the banks have some losses on their bond portfolios and they haven't had to account that when they do their capital calculation. And one of the big changes that this proposal makes is to require those banks to play by the same rules as the very biggest banks. So that means that they will have less capital and therefore the ratio of capital they have to raise capital somehow or shrink assets basically.

GOLDBERG: Correct.

CECCHETTI: [00:23:02] So just to ask a question, is it the case that the analysts don't know this, They don't read the … I can see the unrealized losses. So presumably when they're computing the health of the bank, they're looking at that.

GOLDBERG: [00:23:17] Absolutely. But from a regulatory standpoint, it wasn't a consideration. And now it post Basel III and game world, it will be a regulatory consideration.

WESSEL: [00:23:28] So I think what Steve is saying. Why should it make any difference to investors if it was already on the books? They just in a different a footnote rather than in the capital calculation.

GOLDBERG: [00:23:40] Again, because, banks today that are deemed well-capitalized all of a sudden are not.

WESSEL: [00:23:49] I see.

GOLDBERG: [00:23:50] And actually changed.

WESSEL: [00:23:51] I see. Steve, I'll get you in a minute. So I don't. Anat makes the case that. Well, tell me what you think, Anat makes the case that we're looking at this the wrong way through the wrong end of the telescope.

CECCHETTI: [00:24:02The case that the social costs of capital are likely to be very low, I think is compelling.

WESSEL: [00:24:10] So that means that the benefits …

CECCHETTI: [00:24:14] The benefits and that the benefits are very high, I think is compelling. But I want to start.

WESSEL: [00:24:19] I can't wait. Can you define what you mean by this?

CECCHETTI: [00:24:22] I will in a second. But I want to start with the statement that the bankers when the bankers say that they think that the capital funding is expensive, they are telling the truth. Okay. This is in fact, true.

WESSEL: [00:24:38] Might want to write that down, Greg. I don't know.

ADMATI: [00:24:39] Not socially.

CECCHETTI: [00:24:40I just know from the private perspective it's true. It's true for two primary reasons. The first reason is the tax code, which distorts incentives by making debt cheaper than equity funding. Everybody thinks that's a distortion that's created by the tax code, so it cannot create a social cost and it is not aik, social cost. The second reason that they are telling the truth is because the more the more equity funding you require them to have, the smaller the value of the option is that they have. So it is in fact true that they are facing a cost. But of course, that option is an option to give the bank to the public. So that also cannot be a social cost. So these are private costs. But from the perspective of society, once I take into account the distortions that are in the tax code, and the fact that the government and the people are going to bail these banks out in the end because they always have, then the cost to society cannot be the same as it is to the individual banks.

WESSEL: [00:25:57] All right. So Greg, please, let me let me frame a question and you can say whatever you want? So I think the basic argument is, yeah, we understand the banks don't like this and that's rational on their part. But if we could get the details right, having the banks forced to have more capital would be like buying insurance, more insurance, against something like the Global Financial Crisis. And while the bankers reasonably might not like it, and that's beyond the all the details, things that you and I talked about it. What's wrong with that rationale on the part of the regulator?

BAER: [00:26:37] Sure. I'll get that was just one correction. One of the things Steve said, it's actually not the public that's enduring the cost of these failures. It's the surviving banks. The FDIC has just completed its special assessment, and the price of SVB failure will be paid by the nation's largest banks. I don't think the Deposit Insurance Fund has ever required, , actual long term taxpayer funding. It's a weird sort of system where it's actually a mutual insurance system. We can talk about that at some other seminar. It's kind of fascinating. But yeah, I mean, if you think about the proposal again, I don't think there's any debate certainly among anybody in the markets, any regulators, that as you increase the cost of capital for a given asset, you provide the bank an incentive to move out of that asset or reprice it up to this point. I mean, there's another way that the bank funding is

cheaper. The cheapest bank funding is actually insured deposits, right? Actually, which nobody else gets to offer. Second least the least expensive is, market debt. And then third, of course, is equity. And so and, Jason can attest to this and I've just been hearing actually at the Goldman conference, somebody asked one of the bank, one of the CEOs, what are your plans for the mortgage business? His answer was, well, we'll have to wait to see how the proposal comes out. I think another example that's gotten a lot of attention is, , tax advantaged green energy investments, which the proposal quite quadruples that capital charge. I think all the banks involved have said that that goes for where they're going to get out of that business. So, you can talk about it in the macro sense of more capital is good. And I think you can debate that, but that's actually not what this proposal is about. What this proposal is about is choosing at a micro level which types of assets or exposures to advantage over others. And you won't see banks going out and raising capital. They're not going to do an equity offering. What they're going to do and if you listen to earnings calls and encourage everybody wants to occur to learn about this, to do that, you hear bankers saying we're going to optimize the balance sheet. Here's what optimize the balance sheet means. It means we're going to get out of things that have high capital charges relative to the economic value we put on that asset. And that's why you've seen and that's sort of the thing a lot of people are talking about now, even in some of the regulators, , it's why banks are a small minority of the mortgage market now. And most of those risk, what risk is at Fannie Mae and Freddie Mac and the largest originators are Rocket and Quicken Mortgage. It's why you've seen a massive growth in private capital now private debt, which we didn't used to think it was a thing, but it's now in the trillions of dollars. And, some say it's bad because it's getting pushed to the unregulated sector. I think that's less important. I don't know that regulation makes anything that much safer. But what it's doing, it's being pushed into a sector that charges more and is less likely to continue providing that credit under stress. Because, again, back to the great advantage banks have and pay for. They have deposits. They have insured deposits which don't run. And then they have uninsured deposits which generally don't run. There's a notable case in March, but that makes them --

WESSEL: [00:29:43] They have access to a discount window.

BAER: [00:29:44] And that's very good point. Yes, absolutely. David, I think that if we get to liquidity regulation, I think that's going to become more and more important and ought to be But that makes them durable through the cycle lenders, and that's why you want them to keep making loans as opposed to having hedge funds or venture capital funds or whoever making those loans. And that's what's at stake in this proposal. It's not some esoteric debate about the optimal capital level. Especially in light of the fact that and I think Jason mentioned that when they announced the Basel accord, they said we're not intending to raise capital requirements. You've had now post 2010, any number of economic cycles where the banks have shown no sign that they are significantly undercapitalized, as this proposal presumes, particularly in capital markets, which this proposal hits absolutely the hardest. It's an estimated 70% increase in capital requirements for market trading, principa at risk market making. There's been no indication that that that function is undercapitalized, that it has done well through ups and downs. , most famously, the where you saw in 2020 was whereas the Fed stress test would have predicted that they'd lose tens of billions of dollars, they made tens of billions dollars. So if you live in the real world, it is hard to see anything since 2010 during which, by the way, the average the banks have doubled or tripled their capital, their capital levels to indicate that they are currently significantly undercapitalized.

WESSEL: [00:31:07] It seems to me you're making two arguments now. I want to make sure I get it. One is a lot of the specifics you think are just going to drive banks to move their business in ways that we may not want to do. You mentioned high loan to value mortgages. That's is one I've heard a lot about. But you're also saying that even if it weren't for that, you don't think there's a case for asking the banks to have more capital period?

BAER: [00:31:33] Well, yeah. I mean, there may be some pocket of risk. And again, I mean, if you think about this proposal, actually, they the capital charge for commercial industrial loans actually goes down a little bit. So it's all very episodic or not episodic, but asset or exposure specific. I think in general, in every case, it's probably overstating. I'm sure there's a contrary case. But again, as you look at the and the other thing is we have real world experience. the largest the very largest banks are running what's called the advanced approaches or an internal models based approach. We have the results of that. And it shows that the real world risk weights that are necessary to compensate for actual loss losses and loss given default are significantly lower than what's even in the Basel proposal, much less what the U.S. regulators have added to the Basel proposal.

WESSEL: [00:32:22] Anat is about to explode. --

ADMATI: [00:32:24] Yes, I have about 15 things to say.

BAER: [00:32:26] You can tell because she makes faces and nods her head.

ADMATI: [00:32:29] I know, because I have so much things to say.

WESSEL: [00:32:30] You have a very good poker face, Anat.

ADMATI: [00:32:32] I don't have poker face. I don't have poker face. Okay. I don't even know where to start. First of all, , there are many subsidies of debt that are available to all corporations. And we never see corporations live on solid equity as the banks without any regulation in the real world. So I want to understand why they say they have ROE, that they could increase by borrowing and they don't in the real world that around me here in Silicon Valley, etc. So this entire reasoning is fallacious. What we're talking about is all these subsidies, tax subsidies are incredibly distorting. And that's just bad even for mortgages, but also for corporate debt. The capital ratios were entirely mismeasured, just to mention they were fine for First Republic and for SVB as they failed. So they are not reflecting the true market value of the assets and the banks are insolvent. Now, in my own research, I know how heavily what's different about banking is really the extreme indebtedness that pervades all the time. And that's what we're hearing here. When you have such enormous debt overhang, you behave differently than other corporations. No other corporation talks about what they'll do or not do based on their funding -- only banks. Why is that? It's because their funding is so privileged and so debt based, and that has to be corrected, brought back to markets. To my diagnosis, if you want a corporate doctor, I would say that they would not survive in markets and investors would not agree to support such heavily indebted in, such opaque corporations with equity. So they will reflect that if you increase equity. Now, one final point. We have research showing the adjustments to ratios and to when you tell banks to required to ratio. And some of these adjustments are not efficient and not good for the economy and would cut assets. What we recommend is different tools. The tools do force banks to issue more equity at the price that the market would bear and the market is telling them what their equity is really worth. And that's a good thing. That's the true market test. Stress this: If you cannot raise equity, which is

exactly what happened to SVB, then you're really insolvent. But otherwise you hide you in your insolvency. And that's what we see in some regional banks right now.

WESSEL: [00:34:55] Okay, Greg, before I get back to Steve, can. So Anat makes the point that banks are obviously a lot more leverage than industrial companies, right? That's always been the case. Why should I think of banks and General Motors and Tesla in the same sentence? Aren't banks different given the fact the role they play

ADMATI: For equity

WESSEL: Right. But given the role they play in the society and the fact that the government essentially stands behind them? Steve?

CECCHETTI: [00:35:31] Know you're being brief and so I think that I don't I don't think it's dangerous to put words in Anat's mouth. But I but let me just say that I don't think she's arguing that banks should have the same that banks should have the same debt to equity ratio, the same capitalization as an industrial company. Okay. I think that it is the case that industrial companies tend to have, say, 50%, maybe a third, maybe, maybe, maybe the most leveraged ones a quarter. But it tends to be much higher equity. It's like it's like 50%. I mean, , most households have higher equity than that. So I think that's not the point. The point is that that it should be it should be higher than it is today and significantly higher. I think that I think that, Greg made a really great point at the beginning when he said that this thing is getting really far too complex. Oh, I, I don't I don't think, Greg, that likesome unlike some of my friends, I actually don't think that the Bank Policy Institute is like entirely Darth Vader only like, on the way maybe you're gray rather than black but --

ADMATI: [00:36:56] Too complex I agree.

CECCHETTI: [00:36:57]. But the point is that that the complexity is actually really bad. The complexity is bad for many reasons, some of which you mentioned, which is that the complexity can lead to a lot of unintended consequences because of interactions between, , what's on page 25 and what's on page 2025. And I have no idea then, no person could possibly or even or even A.I.at this point probably figure it out. So I think we do need to think about simplicity, But the simplicity that we're going to that I would like us to think about is similar to the simplicity. I think that I think Anat wants us to think about, which is let's get something really simple and let's assume that people are going to take a lot of risk. And then assuming that they're going to take a lot of risk, what's the right level of what's the right level of capital of equity funding under that assumption? And so, at that point, maybe we can make this thing five pages rather than thousands and thousands of pages, but it's going to end up being equal weighted. And we may have some exemptions, but it'll end up being equal weighted it. It'll be a leverage ratio.

WESSEL: [00:38:13] Greg, your turn.

BAER: [00:38:14] I mean, there's a reason banks are more leveraged than other companies. It's because they hold much less risky assets. So banks hold a lot of reserves at the Federal Reserve. That is a riskless, completely liquid asset. If an auto company held that asset in the trillions of dollars, by the way, collectively for the industry, it it would be a lot more leveraged, Right. A triple-A rated bond does not require a lot of capital to offset the risk of that default. Now, there are other assets that are more risky, a subprime mortgage, for example. But you can't compare leverage ratios at banks versus industrial

companies. They take dramatically more risk. And then I mean, I'm not sure I understood everything that was saying, but I mean, I would just say banks have taken this amazing, privileged position in all their subsidies. And I think I'll turn it over to Jason for more particulars. But they've managed to translate that into trading generally for most, I think, of the regional banks below book value or below tangible book value. They have dramatically underperformed the rest of the S&P 500 since, I think, 2010 to an extraordinary extent. If anybody wants it, I will send you a chart on that. So clearly, investors, the market, are not receiving this as a sort of Pollyanna, idealistic, subsidized, wonderful industry. The word you hear most these days among analysts is uninvestible. So if you have an industry that's uninvestable in the light in the eyes of a lot of people, is trading below book value, and is seeing capital migrate out of that industry into practically every other industry that does not seem like a ripe time to be raising capital requirements on that industry. But Jason knows the numbers a lot better than I do.

WESSEL: [00:40:04] Jason why is that? I mean, and does that imply that the market thinks that they are risky and that they ought to have more insurance?

GOLDBERG: [00:40:14] I wouldn't say the market implies it's risky. I think it just you've created, , a lot of uncertainty, particularly with this proposal and what the ultimate impact will be, because not only is higher capital, but there's several businesses, , that have, , I think increased question marks around them. And, will banks have the ability to increase price and pass that on to the end user to make these businesses palatable or are they going to have to exit , certain businesses? If you think about, this year alone, you've seen Truist exit student lending, you've seen US banks scale back mortgages and auto lending. You've seen, , Citizens Bank just recently exits student lending. And so you’re seeing, banks having being feeling compelled to pull back to kind of optimize or reduce kind of RWA [risk-weighted assets] is in anticipation of these increased cap requirements. And, , this year will be we have data back to the 1930s, the worst year for relative bank stock performance in history. Now, part of that –

WESSEL: [00:41:15] What you mean by relative bank, relative to?

GOLDBERG: [00:41:17] Relative to the S&P 500. So relative to the market. Now, I'm not going to say that's all the Basel III proposals. Clearly, you had, through the four largest bank failures in history contributing to that. But, you do have this kind of, , cloud around the consumer. And if you think about it, financial services is something that the U.S. banking industry exports globally. And now with this proposal on several aspects, you're putting the banks at a disadvantage to their global peers and is actually inhibited their ability to, to compete with international banks operating in the U.S..

WESSEL: [00:41:53] Okay. So let me ask you to put on your hat as not only a bank analyst, but as a citizen. And, we have seen some big banks run into trouble, some of them during the Global Financial Crisis. And you just pointed out that we had the failure of SVB and First Republic, which fortunately didn't turn out to be as big a deal for the economy as many of us feared at the time, but it did provoke a fairly substantial response from the federal government. So how do you weigh what you just said, all those things about Citizens getting out of student loans with the risks that we've seen of financial crises and how do you weigh those things when you think about it, if you're not looking only at bank stocks? Isn't it worth something to lower the odds of a financial crisis?

GOLDBERG: [00:42:47] Absolutely. There's a cost to a financial crisis. And I think coming out of, the 2008-09 financial crisis, there were, we had, the introduction of Basel III, for

example, which by definition means Basel I and Basel II weren't good. And you did have substantial increase in capital. It gets to a point where there's too much capital. And I think that's something we ought to be cognizant of. And, listen, had Basel III end game been in effect on Jan 1, I don't know if that would have changed the outcome of Silicon Valley. if you look at the failure of Silicon Valley, it was a result of interest rate risk mismanagement, interest rate risk, mismanagement, not understanding too concentrated deposit base.

WESSEL: [00:43:31] But the depositors left because they thought the bank was insolvent. if the bank had had more capital, maybe some of them wouldn't have fled.

BAER: [00:43:37] I mean, also they left because they all knew each other around the same email chain.

WESSEL: [00:43:42] Well, we can all agree who to crucify on that one.

GOLDBERG: [00:43:45] Yeah that's no debate. But, I would contend had the Basel III been in place, they wouldn't change the outcome there. All else equal.

WESSEL: [00:43:55] Okay. So let me ask you all a question: A number of the banking groups have said that this will lead to less lending. And they make that point even though most of the increased capital is in the different buckets, in the operational risk bucket and then the market risk bucket that Greg referred to the trading activities. So I just I want to know from each of you, will this result in less lending or is that just a palatable argument because it's easier for people to understand than all the complexities? Steve, do you want to start?

CECCHETTI: [00:44:36] Sure. Well, let me make I'm going to use my privilege just to be here for a second to make a couple quick points, because I failed in my previous answer to say that banks provide liquidity on both their liability and asset side, that's their business. And so they have to have a lot of debt on their liability side or they will not be able to do that. I would sa that's a nuance of what you said, Greg. That's a little bit different. But they're doing it on both sides. They're tend to be good at it. And in in society, we've assigned them that job and we have to make sure that they can still do that job because we want the payment system to work and we want and we want people to have lines of credit. I do have a comment about the ROE thing. I find it very odd that that banks should expect ROEs of pharmaceutical companies. And the reason I find that odd is that pharmaceutical companies face actually existential threats of lawsuits if they start killing people. But banks don't. And so that that sort of seems odd. The other thing is that if you're lower risk, which you will be if you're if you have more capital funding, then you're good. You should be willing to accept a lower ROE because, of course, the idea here is to have is to have risk- adjusted ROE. Now, on the issue on the issue of lending, the first thing I want to say is that we thought in 2007 we had too much debt and too much lending. And now what we're seeing, and the economy is booming. Okay. And now what we're saying is for some reason that we want we want to make sure that lending doesn't contract somewhat. Well, it's contracted a bit, but not hugely. I do not think the evidence suggests that higher levels of capital funding reduce lending. I think higher levels of capital funding, if you look cross-sectionally across banks, banks that are that are better capitalized actually turn out to lend more. They lend more cheaply, they have more, they have cheaper funding and they lend to better, more creditworthy borrowers because the banks that are that are bordering on hitting their regulatory requirements or have very small buffers are going to tend to gamble for salvation. They're going to lend to people who will not be as likely to repay. Finally, let me just say that that I find it a bit surprising that that

the idea of retaining earnings rather than doing share buybacks is somehow going to reduce lending because, of course, that would be the natural way for banks to increase their capital funding. It would be through earnings retention. So is the argument here somehow that earnings retention reduces lending? I find that I find that a little bit a little bit odd.

WESSEL: [00:47:54] Greg, you want to respond?

BAER: [00:47:55] Sure. Just a couple of things on the effect on lending and this I mean, maybe we'll talk about operational risk. But, , the Basel proposal has three components: Credit risk, operational risk. Market risk. The operational risk cap requirements affect lending because they're basically ascribed to one business or another. I'll give you one example very again in the weeds. If a bank originates a loan and sells it to Fannie and Freddie, they actually hold that loan on a balance sheet for I think it's like 60 to 90 days under the proposal that gets an operational risk charge because the assumption is something will go wrong. And that has dramatically increased the capital requirement and would give them a huge disincentive to continue to do business. So just an example of how operational risk products translate over into credit. It gets very complicated and on Steve’s other point. And I want Jason talk more about that. On the ROE, I mean, fair or not, banks compete on ROE against other companies, including pharmaceutical companies. I think one of the ironies and sort of bitterness here, this is a far field. But, if you think about the existential risk to the pharmaceutical company, that they will pay a huge fine if they kill a bunch of people. Banks just I think we're collectively paid over $1.2 billion in fines for not monitoring the personal phones of their employees they paid after the financial crisis. I think tens of billions in fines for not having the notary public in the same room as the person whose mortgage foreclosure documents they were notarizing with no proof that that ever made a difference, that any loan would have been improperly for foreclosed upon. That was tens of billions of dollars in fines. So banks are actually receiving they wish they killed somebody. So there's a lower --

WESSEL: [00:49:49] I don't think you want to say that. But then is that a reason that you could --

BAER: [00:49:52] You could get a higher fine in a bank for an AML violation than major industrial companies have gotten for --

WESSEL: [00:50:00] But I thought that was the argument. So you have operational risk, the risk of getting fined or losing a lawsuit. And the regulators are saying, okay, you should take that into account when you decide the riskiness of your business and how much capital you hold. Right.

BAER: [00:50:13] I think there are two points on that, David, I will make. I've written a fair amount of operational risk. I mean, there are two issues there. One is a question of correlation actually Governor Waller over at the Fed raised this, which is, , if you're going to get an AML fine, is that correlated with a market risk event and a credit risk event? What this proposes --

WESSEL: [00:50:32] AML, anti-money laundering

BAER: [00:50:34] Anti-money laundering or sanctions or not know, looking at your employees phones. Well, the answer is there's no reason to believe that's correlated. So why do you have why do you presume perfect correlation and require all the operational

risk capital to be held in a worst case scenario, to be held on top of all the credit risk capital in a worst case scenario, on top of all the market risk capital in a worst case scenario, plus a Fed stress test, that's a worst case scenario. So why is that all additive as opposed to assuming, well, $1 of capital can take care of different things at different times. The other is back to the worst case scenario. , Banks have paid billions of dollars in fines, but when you actually do the work and we put out some research notes on this, which I commend to you, the amount of capital carried under this proposal is multiple times the worst experience ever. And that's just the Basel proposal. The Fed stress tests again has a further charge. So even if you were going to say, it's perfectly correlated and we're going to require the worst case scenario for op risk, this is 3 to 5 times what that is. And I think that's why there's been a pretty broad recognition that this thing got over calibrated and then is even further over calibrated once you get toto the Fed stress test. And, we're putting out research on there's actually a body I commend them called ORX, which is a basically a data repository for actual operational risk data. I mean, operational risk losses, which the banks globally report to, you can access that data and you can calculate how much do you need in a worst case scenario. And this is again, multiples of what you need in a worst case scenario. And that's again, you're assuming perfect correlation with market and credit risk losses.

WESSEL: [00:52:05] Okay. So, Anat, simple question, will this proposal discourage banks from lending as much or make them charge more for their loans

BAER: [00:52:14] Oh, I'm sorry, I should have answered it. It’s asset by asset. Again, as I noted, I think that a more granular risk rate under the proposal is generally better in terms of a capital charge, commercial industrial loans. That's a good example where you would get less under this approach than under the standardized approach. Currently, it gets even more complicated because there's an internal ratings based approach, right, that the banks use. And I don’t think we can get into that in the time we have.

WESSEL: [00:52:41] So you think not less lending in general but less lending for. Certain things you're saying?

BAER: [00:52:46] Yeah. I mean, and again, it depends on how you allocate the op risk capital. Depends on the Fed stress test. I mean, there will certainly be less lending than there would be, I believe, if this thing had been properly calibrated. So the biggest example is, , they took the Basel risk weights for mortgage and just added 20 basis points to them. Right. If you don't add those 20 basis points, they'll be more lending than if you do. And, the actual risk weight, that's probably valid if you look at actual loss data is probably less than half of that. So, again, it's very asset dependent and it's incredibly complicated, which is why they pay Jason so much.

WESSEL: [00:53:22]. Well, Jason, can I ask you first. Do you agree with everything that Greg said? Will this reduce lending in certain areas? And if so, which areas?

ADMATI: [00:53:33] Are you asking me?

ADMATI: [00:53:35] Okay. Let me ask Jason first. Oh, then you can attack them both more efficiently.

GOLDBERG: [00:53:40] I do agree with a lot of what Greg said. I think there's, there's a whole host of areas. Greg kind of touched on mortgage, particularly higher LTV mortgages for first time homebuyers, We mentioned how it impacts, unused credit card lines. It also

has a higher risk weight for, it treats transactors and revolvers a bit differently. So that's going to weigh on lower end consumer first and have them, potentially less access.

WESSEL: [00:54:15] Can you define your terms of transaction and revolvers. Transaction is someone who just pays their credit card every month and doesn't borrow? And revolver for someone who's borrowing money.

GOLDBERG: [00:54:23] Exactly. And then, operational risk actually plays into the credit card business as well. At the same time, the CFPB [Consumer Financial Protection Bureau] is now going after credit card late fees. So you really restrict potentially reducing the access to lower end consumer has, to credit, the way you look at Basel , for private, smaller, private, small businesses. There are, different nuances on risk weights versus public companies. So potentially putting them at a disadvantage. And there's obviously a lot of small business, middle market companies. And then we haven't talked about it, but, market risk. RWAs increased/ That's actually that potentially adversely impacts, the cost of hedging, whether it's farmers or, corporates kind of hedging interest rate risk or other market participants. Liquidity in the marketplace not necessarily, lending, but liquidity and hedging also has implications as well.

BAER: [00:55:19] I just get one. I just want to I promise to just to pick up on one thing Jason said, because I think it's a good example of the proposal. So the proposal generally has a 100% risk weights for that full $8 of for loans to businesses, And then has a 65% risk weight, so less. if you are a business that is internally rated by the bank as investment grade and has securities listed on a national exchange. What that effectively does is disqualify small businesses, midsize businesses that don't issue securities that trade on the whatever exchange as well as the whole funds business, because funds don't list securities. And you could say, okay, well, maybe that's right. Maybe they're more risky because they don't have securities listed. And actually, one of my colleagues, Francisco Covas and other economists, have done research and they've shown using historical data and with a robust data set that if the bank rates it investment grade internally, the loss given default and the probability default are no difference, no different based on whether you have securities listed or not. So it's like little things like that, but that will make a massive difference to the ability and that's why we're starting to hear from small businesses. And, this is are all about Washington now that will make a massive difference in the competitive ability of small, small, midsize businesses versus large businesses.

WESSEL: [00:56:38] It's almost as if you're saying if they want to raise the capital requirement, that's okay if you don't like it, but you're really interested in turning the dials a little bit to one side on a lot of these specific things. Am I reading you right?

BAER: [00:56:56] Maybe I just I disagree with Steve here. I think it's okay to make I think it's good to make the system more risk sensitive than it is.

WESSEL: [00:57:06] Right, to charge, If you have a bank that's making a lot of risky loans, have them hold more capital than a bank which is only buying treasuries.

BAER: [00:57:12] Correct. And but even within asset classes to make it. But the other really odd thing about this proposal is that the most granular and accurate way to assess risk is to use the bank internal models that actually look at loan level detail since 2014 that the large, very largest banks have been doing that. It has been, by all accounts, a success. There's never been any accusation that they're misstating the risk. There's a whole system of compliance and audit and examiner oversight and back testing to supervise that

process. And more, not more importantly, equally important. the Basel accord of 2017 actually said, well, we have some worry that there will be unwarranted variability among what different banks are producing with their different models, but we're going to let them continue to do it. But we're going to have subject to what's called an output floor where it can't be less collectively than 72.5% of what the standardized government model shows. So that was the grand compromise of Basel, which was continue to allow internal models because they're more granular and more accurate. But just to make sure that there's not unwarranted volume variability. We're going to have a sort of a parameter around that. And what the U.S. proposal has done without explanation is to say, no, we're not going do that at all. We're just going to put everything in 100% risk weight. We're not going to allow use of internal models at all. And we're going to go 100% basically to set the output for not at 72.5%, but 100% only for U.S. banks in an approach that has not been adopted by Europe or the U.K. or, to my knowledge, any major jurisdiction in the world. So we will, after this proposal, is adopted, if this proposal was adopted, I should stress, we'll be the only country in the world where your capital requirements for credit are set solely by government models. And what's even odder is that the regulators actually allow banks to use their internal models for market risk, which is significantly more complicated than credit risk, and for the Fed stress test for credit risk. So it's hard to escape the notion that perhaps they're not using internal models simply because they're producing a lower capital charge than they might prefer for political or other reasons. But there's certainly no data to suggest that those models are less accurate as opposed to dramatically more accurate.

WESSEL: [00:59:19] Anat, can you answer. I understand your point about what you would like to see the system be, but given this proposal, do you think the banks are correct in saying, as has Greg and Jason have said, that this is going to end up with less lending, particularly in the areas where the risk weights have been dialed up?

ADMATI: [00:59:39] It's possible. I cannot say for sure. What I'm saying is that on the margin, the problem is not one of lack of funding. The problem is one of what you want to do and you're telling me you want to maximize your profits. So that's what you're going to do. Now, some loans are made, so you can't have it both ways. If the loans are only going to be made by somebody. Then that's maybe okay. As it turns out, research by colleagues of mine showed that non deposit taking lenders Quicken and these other shadow banks have much more equity and they're not even regulated to have as they have twice more than banks. So that's that. And I don't also have a lot of sympathy for the argument about, international comparisons. To the point that I, the Credit Suisse affair, which was not mentioned here but is relevant, shows us that cross-border and systemic resolution is just dead, is not workable, is never going to work, and it just not going to happen. Therefore, we start questioning the need for actual global banks that have operations in multiple jurisdiction or are systemic in multiple jurisdictions. If you cannot fail that's not a capitalist economy, that is above the law and that's not okay with me having corporations as big as complex and global that cannot fail is very dangerous and very unhealthy. So for me, I think we have to revisit that question of too big to fail. Dodd-Frank promised us to end it and it didn't.

BAER: [01:01:16] Well, I just I remember Credit Suisse a little differently. I think the equity holders were all but wiped out. It gets very complicated around why they got a little smidge left. In fact, the long term debt holders, what they call AT1 and in the US what we call.

ADMATI: [01:01:33] No, no, no, $50 billion never touched $50 billion was Swiss francs 81 lacs were not. 81 was just 17.

CECCHETTI: [01:01:41] Get we get back to the U.S. case?

BAER: [01:01:43] That they suffered a total loss on the --.

ADMATI: [01:01:45] Just --

CECCHETTI: [01:01:47] Very nice work here. Gregg, you'll agree those were very weird bonds. Yes, it was $15 billion. These were $15 Billion worth of bonds that were subordinated to equity. Yeah, that the other stuff, the next tranche up.

ADMATI: [01:02:01] The TLAC

CECCHETTI: [01:02:03] The TLAC was not touched.

BAER: [01:02:04] Qualified TLAC.

BAER: [01:02:07] We're off topic. I think Credit Suisse is an example of how the TLAC requirement works, not how it doesn't.

WESSEL: [01:02:13] Okay. So let me let me. We'll do that another time. So a couple of people have asked the question. This is something Greg raises. Steve, I'd like you to start. If we ask the banks to hold more capital, particularly against some of these, have more capital, sorry, these assets that are deemed risky. The argument is made that this business will just leave the banking system and go to non-bank financial institutions that are not as regulated. One person suggests that the banks will just simply finance these risky companies outside of the regulated banks, and that might make even financial instability more likely because we have much less visibility into them and they have less the safety net. Someone else says that: Are we increasing risk in the system? If the risks tend to migrate to less well-capitalized players? So I think this arguments made a lot that basically if you we have a regulated system and a lot more lightly regulated system, will just chase the business out. A) Do you believe that? B) Should I worry about it?

CECCHETTI: [01:03:27] So the first thing is that the banks are the most leveraged, lowest capitalized entities out there. It's complicated to figure out what leverage is and some other types of institutions because of derivatives exposures. But by and large, banks are probably, I don't know, anywhere from 4 to 6 times, maybe more leveraged than people outside of the banking system. And so I actually worry much less about non-bank intermediation and the instability that it could cause than other people do. We've seen a lot of we've seen a lot of things that look like large events outside of the outside of the banking system and turn out not to be not to be very, very important if it's the case that banks are lending into those institutions. Then, of course, the banks are facing the same risk charges in the same the same capital charges, the same operational risk charges than they would otherwise. It may be that those that those institutions are better at managing the risk than the banks are. In which case they should be treated better in the in the capital requirements. So I'm I actually think that the movement of finance outside of the of the very highly leveraged banking system is largely stabilizing the movement of it into the markets, which is a lot of what's going on here is also largely stabilizing and the movement of it into int other private securitized or funded and purely funded and market funded entities also looks to me to be stabilizing.

Let me make one very small point, which is that that since 2009, we have not seen a serious recession which didn't come along with incredibly high government support for

everybody. So it's very hard for me to look at the data and say, oh, credit risk is actually really low because I have no idea what's going to happen if if we actually have, let's say, a run of the mill pre 2007 recession, which I think looking at everybody here will all be enough to remember where we have, , a year of minus-3% growth. I just don't know what's going to happen. It could be that we're going to be better off. It could be that we're not. But anyway, I do have I do have actually quite a bit of sympathy for Greg's point about the I.R.B. [internal ratings-based]. approach. But I will say that one of the reasons for the output floors is that there was an incredible variance across banks in in the in their risk weights. I mean, on the order of 2 to 5 times then we did the original calculations for the calibration of Basel III, which now also seems like pre-history. But there were incredible, incredible variations. So in some sense, they brought this on themselves.

BAER: [01:06:41] So I just say I, I think I take issue with that in point and I'll send it to you. But we have a research note coming out I think this week on warranted versus unwarranted variation in bank reported.

WESSEL: [01:06:54] Is it is agreed that the risk weight for the same asset should be the same across banks?

BAER: [01:07:04] It's a little nuanced. So, probability of default should be the same loss given default probably should not be the same. So the easiest example is imagine two banks, one has a large workout group, the other. it just puts you into bankruptcy and sells the loan. They should not have it. Interestingly, apparently some of the variation is caused by regulation and examination. So it's a it's very subtle. But what my colleagues, I think Greg Hopper, Francisco Kobus have a note coming out imminently, basically taking a deep dive. Look at this. I'd really recommend it. And then I guess the only other thing I'd add to what Steve said, I mean, I don't think it's leveling off. I'm just reading a Morgan Stanley report that says the size of the private credit market was $875 billion,000,000,000 in 2020 has grown to $1.4 trillion now and is estimated to go to $2.3 trillion by 2027.

CECCHETTI: [01:07:53] That's a pretty small number -- look at the bank balance sheets -- no, but 10% less.

BAER: [01:08:02] A lot of this just comes down to, do you believe the maturity transformation? Do you believe there's a social benefit to banks issuing to insure deposits and having discount window access and, , back to, , banking 101? The basic notion is the reason you do that is that that gets people loans cheaper. I don't think anything's really changed about that. And also, as I was noting earlier, it gets people loans even in dark times because banks continue to fund because their deposits generally hang around and the discount one is there etc. But , that's a whole nother, y'know.

WESSEL: [01:08:31] So you're not you're not making the case that we're going to have more financial crisis because of this private credit thing. You're saying when times get bad, those guys will not be in the business and we might not have the same maturity transformation.

BAER: [01:08:44] That's I think that's I mean, that's a that's a good question. I think to the extent that they're not short term wholesale funded like a Lehman or Bear Stearns, then yeah, that's less of a risk of a financial crisis. On the other hand, there's been a lot written recently about the hedge funds that are incredibly leveraged around this trade. I don't know enough about that trade to know the systemic risk inherent in it, Actually, Jason might. So I think it's not clear that it's more systemic risk. I just don't know.

WESSEL: [01:09:13] So, Jason, so what do you make of the argument that we're just going to chase all this business outside the banking industry and that's a bad idea. That's for the banks, not only for the banks, which obviously want the business, but for the rest of us.

GOLDBERG: [01:09:25] I think, Greg makes a good point. It would be interesting to see, , where private credit is when the economy really weakens because they don't have the stable funding that the banks do from depositors. They rely on market funding, which could dry up very quickly. I think the other important consideration is I think banks and nonbanks financial sometimes have different objectives. I think banks approach customers as relationships. They do multiple products and services. For those companies, in many instances, they've had these customers, , for 100 years in some cases. So when a loan goes bad, they actually work with the borrower to come up with a solution. Whereas, private credit, I think has different objectives and different relationships and it's solely on a financial return. So you think about how this whole, what's going on in the office sector at the moment is playing out. You've seen banks, in many instances kind of restructure loans, work with borrowers, have borrowers put more equity in and, , try and work out the situation where you've seen, some private or hedge funds or private equity investors just take the building and sell it at, fire sale prices to be done with it because there's just a different relationship there. It sounds to me like one of those outcomes is better than the other for society as a whole.

WESSEL: [01:10:48] Anat, what do you make of the argument that we're going to chase a lot of business out of the regulated banking industry? Should I worry about that? Let's say it's true. Should I worry?

ADMATI: [01:10:56] I'm not as concerned about it. And I also think that a lot of this shadow banking goes if you trace the money into the banking system itself. So I don't know that this system is not connected at every level within it. Money market funds are, a shadow bank in the middle between a depositor and a bank. And so,the risk just starts, being still around but just being counted differently. And in all of that. So I worry about chasing the risk to some extent. And I think it's in the system. Now, what I also didn't say about lending is that, we don't go around asking that much except in the vaccine case. what a company invests in a loan is an investment for the bank. We don't usually micromanage that. Why? We have, some loans are good and some loans are not at the price that they are charged. Now we're talking about subsidizing some loans. My big picture point really is for all of us to think about who we want to subsidize and for what purpose. So, for example, we give a tax deduction for mortgages. Not all countries do that. That is really regressive and that doesn't make any sense. If we want to subsidize first time homeowners, we can give them, a tax credit for a down payment on a house rather than subsidize high income people to borrow to buy a house. You have Peter Thiel here taking a huge mortgage to buy a mansion. Why is that should be that subsidized by taxpayers? That doesn't make sense to me. So that that's at the mortgage level. So what I'm saying is, , there are just subsidies in there. They're given in distortive ways. And I think that's unhealthy. , for the entire system. And that is true for the fact that the economy is very debt fueled and that we keep talking about loans without asking why do people need a payday loan? Why do why is there so much? Why are people living on borrowed money? So as much as they do, I understand the role of debt in the economy. But I think we have excessive uses of private debt in general and subsidies going straight to debt as opposed to what we want.

WESSEL: [01:13:22] Okay. So we have a couple of minutes left. I was going to ask each of you to make one big point about bank capital. Anat, you already spent your minute. So, Jason, if you were speaking to members of Congress, readers of The Wall Street Journal, The New York Times, people who don't live and breathe this thing, what is one thing they should know about this bank capital proposal?

GOLDBERG: [01:13:46] I would just say, there is something as too much capital. And I'm concerned this proposal, as is, goes too far. And, I think, , the Fed has talked a lot about the need for consensus. And you've had a lot of dissents already, both inf the Fed, in the FDIC. And I suspect there'll be a lot of comments. And I just hope they're all considered in the final proposal.

WESSEL: [01:14:09] I think Michael Barr said on the record they're going to make some changes. He gave a list, the familiar topics. Greg, what's one thing you think people should know about the proposal?

BAER: [01:14:19] I mean, I think just in terms of how to propose a proposal, you don't have to be a weatherman to know which way the wind blows. And if you just look at what's happened over the last ten, 15 years, is the problem that there's not enough capital in capital markets for the dealers or is the problem that market depth is way down and in fact, we have gross concerns about liquidity in those markets and we've had the Fed having to bail out the Treasury market both in 2019 and in 2020?. , On the credit side, again, are we seeing banks with massive credit losses that are bringing them down? Are we seeing, credit migrate out of banks to other institutions? It seems like all of the actual weather seems to indicate, as Jason said, that almost without exception across asset classes, banks are amply well-capitalized. And we haven't even talked about the fact I mean, the Fed puts a lot of stock in its Fed stress test. They've been running it every year since the crisis. Every year it says the banks have ample capital. Are they were they wrong all along? So, I think whether it's that experience, which obviously the Fed's test is hypothetical, although they use actual balance sheets or whether it's what's actually going on in the market. I think if you do a reality based assessment of bank capital, we've got plenty.

WESSEL: [01:15:34] Steve, last word.

CECCHETTI: [01:15:36] Get some of these things to say some little time. The I had a rule when we were when I was in Basel and we were working on this. And my rule was that if the people that are creating that are creating spillovers and systemic risk, the people are creating risks of financial crises or not screaming at me when I'm trying to get them to actually internalize the costs. If they're not yelling, then I'm not doing my job. So my job now is to ensure that I am helping so that the people in the banking system and in the financial system are screaming about this. Because I want them, if they're not screaming, then I'm not being tough enough. So I find this conversation, it's very illuminating. I really appreciate I really appreciate all of the points that Greg and Jason have made. I think that hopefully we've all made coherent points, but in the end, my view is we have to raise capital requirements. We have to make sure people are that the banks have sufficient capital funding so that their incentives are aligned with those of society, not with those of their managers and the like.

WESSEL: [01:17:00] Okay. Well, I said at the beginning that I knew we weren't going to resolve the questions, but I hope we could shed some light on them. And actually you all exceeded my expectations. Now, that may have something to do with my expectations, but

I want to thank you all for being so clear and even at times succinct, which is always a challenge in these things. I suspect that we'll be doing this again and again and again and again. This isn't going away. But for now, I want to thank you and all the people who dialed in.

BAER: [01:17:30] And thanks, David. That was great job of moderating. Thank you.

CECCHETTI: [01:17:33] Thank you very much, David.

ADMATI: [01:17:34] Thank you all. Bye bye.