Minutes of the November 18, 2016 Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, John Geanakoplos, Darryll Hendricks, Charles Himmelberg, Bradford Hu, Deborah Lucas, Lynn Paquette, Stephen Ryan, Tano Santos, David Scharfstein, Antoinette Schoar
FRBNY: Tobias Adrian, Gerard Dages, William Dudley, Thomas Eisenbach, Beverly Hirtle, Antoine Martin, Meg McConnell, Simon Potter, Kevin Stiroh, Michael Strine, Joseph Tracy, James Vickery

This meeting of the Financial Advisory Roundtable (FAR) considered how bank business models are adjusting to the new regulatory environment. The meeting commenced with two prepared discussions from roundtable members on how new regulations are impacting the cost of capital, capital budgeting, and activity in the banking sector. These comments were followed by an open discussion focusing on the issues listed in the meeting agenda.

The regulatory environment and the cost of capital

FAR members indicated that in determining how to allocate capital internally, banks assign a cost of capital to different investments. This cost of capital is determined in part using models that aim to maximize a measure of shareholder value subject to a set of regulatory and risk-based constraints. FAR members argued that, while this general approach was also used before the financial crisis, the capital allocation process has been modified to incorporate new regulatory constraints, such as new capital adequacy and liquidity requirements as well as stress tests undertaken as part of the Comprehensive Capital Annual Review (CCAR).

The discussion identified the significant increase in the number of regulatory constraints as one of the important changes in the post-crisis era. FAR members noted that it can be difficult to determine which constraints are binding both across institutions and within institutions across business lines. With this caveat in mind, FAR members suggested that capital requirements based on risk-weighted assets tend to be more binding for banking organizations focused primarily on lending to firms and households, while leverage constraints based on unweighted assets such as the supplementary leverage ratio tend to be more binding for firms engaged in a broader range of activities such as trading, custody services, and securities lending.

It was observed that leverage constraints based on unweighted assets may discourage activities that entail limited economic risk but increase the size of a firm's balance sheet. Closely related, some FAR members argued that some banks are being incentivized to shrink low-risk, low return-on-asset (ROA) businesses in favor of high-risk, high ROA businesses. FAR members also suggested that the presence of multiple constraints encourages firms to broaden in scope across traditional and nontraditional activities. Going forward, some FAR members argued in favor of a less complex regulatory environment with fewer constraints and less emphasis on constraining leverage.

Other FAR members took an opposing view, arguing that excessive leverage in the banking sector creates an externality because of deposit insurance and spillover effects of financial crises on the broader economy; the costs of capital regulation must therefore be weighed against the social costs of leverage. It was also argued that high leverage can increase asset price volatility, which may be undesirable from a financial stability perspective. With this in mind, it was suggested that a shift in risk-taking from large systematically important banks to smaller financial intermediaries may be a positive development. As an alternative to the current framework, it was suggested that leverage constraints be applied on the underlying assets (e.g., loan-to-value constraints on mortgages, or margin requirements at exchanges), as opposed to imposing leverage constraints on institutions.

Members also discussed the distinction between the average cost of capital for a business line and the marginal cost of capital for a particular activity or investment. In a textbook setting, each loan, trade, and banking activity would have its own marginal cost of capital reflecting the economic risk of the activity. In practice, some FAR members argued that this is impractical because of the operational difficulties in centrally determining a marginal cost of capital for the large range of activities that banks perform. As a result, managers must generally determine which investments to make given an average cost of capital for their business.

FAR members also expressed a range of views about which measure of shareholder value banks can and should attempt to maximize, and whether return on equity represents a good measure of shareholder value creation.

Bank activity in the post-crisis era

FAR members also discussed how the new regulatory environment is affecting bank business activities. One FAR member argued that the most important regulation has been the Volcker Rule, which aims to prohibit proprietary trading by banks. Other FAR members felt that the overall impact of the Volcker rule was more limited, however. FAR members expressed uncertainty about how the Volcker Rule will impact the trading and market-making businesses in the future. Some FAR members also argued that the Volcker Rule does not clearly define which activities are permitted, and argued that there is not always a clear distinction between holding inventory for market-making purposes and proprietary trading.

Another topic of discussion was the provision of traditional banking and prime brokerage services. One FAR member observed that banks are now more reluctant to provide checking accounts to prime brokerage clients, such as hedge funds. FAR members suggested this trend may reflect regulatory factors or instead be due to the low interest rate environment. Along a different dimension, it was noted that changes to the provision of prime brokerage services may interact with other businesses that banks are exiting. For example, to the extent that it is now harder to obtain leverage from prime brokers, it may be more difficult for brokerage clients to profitably trade against low-risk, low-ROA opportunities.

Legal risk and complexity

Another question that emerged from the discussion was: why hasn’t the cost of capital for banks fallen more as the level of capital has increased in the post-crisis era? FAR members suggested several possible explanations. One member suggested that reassessment of legacy legal risks may have offset the reduction in risk due to lower leverage. In addition, members noted the possibility of heightened legal risk going forward, for example, in relation to uncertainty about compliance with new regulations such as the Volcker Rule. Beyond legal risk, it was also suggested that the cost of capital will remain high for banks because their opaque assets and liabilities make them difficult to value. As a result, investors continue to demand a high return on equity for the sector.

In addition, it was observed that regulation interacts with complexity. FAR members suggested that the cost of complying with the current regulatory framework has the potential to create economies of scale, encouraging large banks to grow further and expand into new business lines. To the extent that this makes banks more complex, it has the potential to raise their cost of capital. On the other hand, new regulations and legal risks have encouraged banks to improve risk management, strengthen corporate governance, and invest in technology and data, which would tend to reduce risk and thus lower the cost of capital. It was also suggested that there may be benefits to not fully disclosing stress testing methodologies in CCAR, as this allows capital regulations to adjust more dynamically to changes in the macroeconomic environment and financial system.