The Problem of Fail-Safe Banking*

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One of the goals of the Dodd-Frank Act and the deluge of regulations issued thereafter appears to be to create a fail-safe banking system. The reasons for this reaction to the financial collapse are understandable. Excesses in the financial markets resulted in widespread harm to our economy, and to the lives and well-being of millions of ordinary people. Both Congress and the regulators have adopted policies designed to prevent financial institutions from engaging in practices that they view as unduly risky. In other words, one goal of these governmental actions is to create a fail-safe banking system, in which banks are constrained in their risk taking activities, and the failure of a significant size bank will be a highly unlikely occurrence

The methods chosen to achieve a fail-safe banking are easy to discern. Capital requirements for all banks have been increased dramatically, and even more so for the largest banks that have additional capital mandates in the form of “buffers” and “countercyclical” add-ons. Mandatory liquidity requirements have also been developed that will require banking organizations to hold large portfolios of Government bonds. Banks’ investment authority has been circumscribed, and traditional banking activities, such as mortgage servicing, have been forced out of the banking system. Mortgages must meet a subjective “ability to repay” standard. Stress tests, living wills, and regulatory directives have also been imposed. Department of Justice lawsuits and regulatory agency enforcement actions reinforce the belief among many bankers that loans made to anyone with less than a stellar credit rating carry additional risks should the borrower default. And the use of the securities market to provide funding for new loans has been discouraged through risk retention and other requirements.

There is no question that the new regulatory paradigm is designed to limit the riskiness of engaging in a banking business. There is a significant question about whether the reaction to the financial crisis has gone too far.

Banks, by the very nature of their business, are supposed to take risk. A loan is a risky asset. Much riskier, for example, than an investment in a Government bond, or a highly rated corporate debt instrument. By taking risks, banks provide capital to those who want to start a business, expand an existing business, develop a new product, or purchase consumer goods. These ventures are the engines that drive our economy, create jobs, and improve our quality of life. But these ventures also fail, resulting in losses to both the individuals involved and the banks providing the finance. A bank that doesn’t take risks, that doesn’t have losses to write off, that doesn’t make a loan based on the soundness of a business plan or new idea, is not

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doing its job. That bank may be fail-safe, but it is a bank that is not providing the capital our country needs to grow and develop. As House Banking Committee Chairman Wright Patman warned in 1963, a lack of bank failures in that era was an indication that the system had moved "too far in the direction of bank safety."

This is not to say that there should be no controls on bank lending. As we have seen, unrestricted lending for housing led to a financial disaster. But, when the corrective pendulum swings too far in the other direction, the results also can be harmful to our economy. Neither fail-safe banking nor wildcat banking is appropriate. A return to the middle ground, where prudent lending practices are required, but where losses are tolerated and expected, is the best solution.

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