AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Friday February 1, 2013

BANKTHINK

High-Stakes Policy Decisions Loom

By Eugene A. Ludwig

EUGENE A. LUDWIG
PROMONTORY FINANCIAL

Expect 2013 to be a momentous year for banking. An enormous number of new rules are slated to be finalized a result of Dodd-Frank, Basel III and other regulatory initiatives. The result will be the largest augmentation of the banking rulebook in history. Yet how these rules will be finalized is far from certain.

Here are a few areas where the stakes are highest:

Community banking: Unless you have spent time working with community banks, it is hard to appreciate how profoundly modest changes in rules and supervision can affect them. Many compliance burdens have nothing to do with safety and soundness. I still remember my early years as comptroller of the currency, when a community bank CEO called to complain about the number of examiners we'd sent to his main branch. The examiners had taken up all the spaces in his parking lot, and the bank could not do business.

I solved this problem by asking my examiners to park elsewhere. Other burdens are not so easily addressed, but easing community banks' burden is critical. Today, community banks are larger enterprises than they were 10 years ago. They should be defined by the products they offer and their willingness and ability to serve their communities, not by their size. By this standard, and almost without exception, banks with assets below $10 billion are community banks. The same is true of many banks with up to $50 billion in assets.

A look at five areas where the stakes are highest, from community banking to shadow banking.

The Basel III proposals — which create a new definition of capital and a new, U.S.-only standardized approach to the calculation of risk-weighted assets — could be profoundly disruptive to such community banks. U.S. regulators understandably want to make the Basel standardized approach more risk-sensitive, but small banks with no international presence should be exempt from it. This initiative is not required or even suggested by Dodd-Frank, and it should not be part of the sheaf of new compliance obligations facing community banks.

The Volcker Rule: Like it or not, the Volcker Rule is here to stay. The issue is not whether proprietary trading should be pushed out of banking organizations—it is whether the rule allows for appropriate market-making and hedging activities, as Dodd-Frank demands.

There are two dangers here: narrowness and complexity. The final Volcker Rule could be drawn too narrowly for banks to make markets for clients, facilitate the issuance of securities or engage in hedging activities that are critical to bank safety and soundness. It could also be so complex as to become a trap for the unwary, resulting in disruptive, contentious examinations and enforcement actions that make market-making and hedging activity impossible to conduct economically.

Housing: As proposed, the Basel III and qualified residential mortgage rules make loans to first-time and low-income homeowners much less accessible and likely more costly. A large-down-payment requirement, like the 20% one in the proposed QRM rule, would have the greatest impact on homeownership for low- and moderate-income Americans. Private mortgage insurance is not incorporated as a way to bridge this problem.

This is problematic in a variety of ways. But other pending rule changes present their own implementation challenges. They include tougher servicing standards, high-cost loan appraisals, loan officer training and loan originator compensation. Taken as a whole, they are likely to force basic changes to the business models of mortgage originators and servicers.

Ring fencing and free trade: Rules and proposals here and abroad move us toward the application of national regulations, national organizational structures, in-country capital and even national accounting treatment for global banking organizations. This balkanization could be disastrous.

Notwithstanding the imbalances and shocks that have been so painfully evident in recent years, we should not lose sight of the fact that free trade, including free trade in banking and other financial services, has produced a considerable rise in global economic well-being. The U.S. has historically played a leadership role in promoting free trade. Since World War II, it has sounded the trumpet against a return to the disasters of the Smoot-Hawley Tariff Act.

However, global economic strains have pushed us ever closer to a patchwork system of territorial financial rules, which press global banks to calculate capital and liquidity on a country-by-country basis. They move institutions away from global governance and toward a territorial system that is inefficient and ultimately unsafe. The Basel accords are not always perfect, but they are far superior to isolationism.

Shadow banking: One toxic byproduct of rules that are too complicated or unnecessarily burdensome is the growth of the shadow banking system. Virtually all recent financial reforms are aimed at banking organizations, along with a small number of nonbanks that are systemically important at a global level. This leaves ample room for nonbanks to take up financial activities without the growing compliance overlay that banks face. As a result, one of the fundamental goals of financial reform — to improve market stability — is threatened by that very same reform.

These are only a few of the areas where major changes could occur. Regulators have been wise to take their time to try to get these changes right.

Eugene A. Ludwig is a founder and the chief executive of Promontory Financial Group LLC. He was the comptroller of the currency in the Clinton administration.