

## **What Now?**

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What now? In the post-crisis world, bank supervisors have taken on two challenges: first, you have committed to place effective limits on bank risk taking and, second, you have committed to arrange bank capital structures to reduce the likelihood of taxpayer losses. Can you do this? Yes, I think you can. But to be successful, you will have to change your own behavior, and the behavior of bankers, more than is apparent thus far.

Before you can effectively limit bank risk taking in general, and risk to taxpayers in particular, you will have to take view on *how much risk banks should take* and, correspondingly, *how much reward they should seek*. While bank management and bank boards are responsible for this in the first instance, you will not be able to assure yourselves that risk is effectively limited without making *hard judgments* about risk *and* return – “hard” both in the sense that these judgments are *difficult to make* and in the sense that you need to be *prepared to make them binding*.

### *Summary*

Taking a view on the appropriate level of risk and return will be difficult. There is considerable uncertainty about where returns to financial capital should settle in the post-crisis world. You will also have to stop your habitual reliance on the idea that the risk-weights provide an automatic process that calibrates risk and capital without your needing to make hard judgments.

Bank capital structures that protect taxpayers’ interests can be achieved but only, in my view, when traders, bank executives and bank supervisors give up the free options they now hold. Traders must give up the free option of converting assets into derivative exposures with a preferred status in the capital structure. Bank executives must give up the free option to avoid raising common equity when it is most important. Bank supervisors must give up the free option of deciding *ex poste* how to allocate the costs of systemic resolution.

### *Difficult judgments, shedding bad habits*

Over the last 30 years, financial intermediaries have experienced extraordinary returns as the consistent decline in interest rates pushed up the value of all future cash flows. Without this “total return” wind at our back, banks and other intermediaries will struggle to achieve the earnings growth to which we have become accustomed – and that pay for our capital structures.

With central banks now attempting to solve for the zero-interest-rate boundary by hoarding assets and, thereby, forcing bankers and investors to re-balance portfolios into other risk assets, judging how much risk a prudent banker should take is difficult. With many measures of volatility seemingly suppressed, and a growing realization that volatility itself is not a good measure of the discontinuity risks we face from policymakers and politicians, should we take on more risk in order to achieve our expected returns or should we adjust downward our return expectations for a lower growth, lower return world?

I suspect that it is more the latter than the former. But that’s just my opinion. If supervisors are going to place effective limits on bank risk taking, while ensuring that banks have adequate earnings to pay for their capital structures, *you* will need to take a view – on both risk and return.

This will be especially difficult because we have all developed the bad habit of thinking that we did not have to make these hard judgments. We thought risk-based capital would do it for us. But risk-based capital failed us.

I speak now as a former central banker and one as guilty as anyone of the mistake of thinking, in the late 1990’s, that we did not need to worry about bank asset quality because risk-based capital would take care of that for us. We thought that we could focus on inflation targeting and good macroeconomic outcomes. The risk weights would ensure that bankers who took too much risk would hold a correspondingly higher amount of capital. The process would work all by itself. The science of the risk weights would ensure safety and soundness and an effective monetary policy transmission mechanism.

But it did not work. We misjudged the risks and we did not require enough capital. The risk-weights did not capture the risks bankers took.

But more importantly, risk-based capital failed us as a way of thinking about supervising banks. The idea that bankers can take as much risk as they like, provided they hold enough capital, is the wrong starting point. Beginning the analysis with decomposed risk elements – counterparty risk, liquidity, leverage, market risk – is also a mistake. Instead, we should begin by looking at the business lines, ask how they generate their P&Ls, whether the process is sustainable, and then ask management to limit risk-taking to fit within the parameters of their capital

and their prudent return expectations. But what should those “prudent return expectations” be?

*Income-based credit, not asset-price momentum*

A critical limit on the earnings potential of bankers is the ability of borrowers to repay loans out of income and not out of the momentum in asset prices. We need bankers to shed the habits, acquired over the last 30 years, of thinking that lending against *rising* collateral values is a suitable substitute for scrutinizing the ability of borrowers to repay their debts.

Every credit bubble in history has at its base the mistake of lenders focusing on rising asset values and taking their eye off of the borrowers’ ability to repay out of their current income or assets *other than* the loan collateral itself. It does not matter whether the collateral is Tokyo commercial real estate, Dutch tulips, houses in Stockton California, mortgage-backed securities, or European sovereign debt. The mistake is always the same. Bank supervisors need to begin by grounding bankers’ return expectations in the reality of their customers’ cash flows.

*How to run a bank*

Still, the difficult question remains: how can supervisors place effective limits on bank risk taking and return seeking?

I do not think you can do this unless you have some view on how to run a bank. So how would *I* run a bank and how would *I* supervise a bank?

My first step would be to ask: How many P&L centers does the bank manage to? By “manage to” I mean accrue distinct compensation pools tied to P&Ls that differ from each other and from the bank as whole. I would then ask whether we can take the sum of those P&Ls and come up with the bank’s reported P&L.

The second step would be to look at each P&L center that is generating “above average” returns – above average for the bank or for the industry – and ask “how do they generate above average returns?”

There are only three reasons why you can generate above average returns: because you are “good”, because you are “lucky” or because you are “doing something wrong”. Good can mean that you have special insights or technology, a powerful brand, a unique market position or some genuine competitive edge. Lucky means that you do not really know why or how you are generating those returns. Doing something wrong covers the gamut from merely employing too much leverage all the way to front-running or illegally abusing your clients. Note that two out of the three reasons for running above average returns are “not good”.

Unless and until you make a judgment about how each P&L center generates its returns, as well as how they *calculate* their returns, whether you are running the bank or supervising it, you cannot have an informed view on whether too much (or too little) risk and return are being sought.

My third step would be to ask for the bank's *ex ante* estimate of the volatility of returns for each P&L as well as for their calculation of the realized volatility of each earning stream. This will permit us to gauge their risk-adjusted returns and also to see if they are any good at estimating the volatility of returns at the level of the business P&Ls on which they base compensation. This step is critical to setting effective limits on risk taking.

Finally, I would turn my attention to those areas with average and below average returns to ascertain how they are generated – good, lucky or doing something wrong. Having triaged the sources of returns for all P&L centers, I would promptly scale down or shut down all the P&L centers that are doing something wrong.

Difficult judgments will come in thinking through how to set right the ones that are merely lucky. But part of the process will be to require much greater capital against risks taken in businesses that appear to be just “lucky” with no demonstrable persistence in their revenue stream.

The hardest judgments will come in thinking about the P&Ls with below average returns and whether they should be scaled down, shut down or whether they are about to mean revert to average or above average returns. There will also be hard judgments about when in the cycle each “good” P&L center should be scaled down because the opportunity is fading or they are losing their edge.

Throughout these steps I would be asking whether bank management actually understands how their different businesses generate their returns, whether management is actually in charge of internal capital allocation, or whether it is just a recipient of the risks and returns which the different P&L fiefdoms throw off.

Now these analytic steps may seem too simple, too elementary for your taste. Permit me to speak plainly. If supervisors had just done the first step I suggest – of identifying each P&L center and seeing if they sum to the bank's reported P&L – they would have identified the “London Whale” long before it was beached.

Too many bankers do not understand the difference between a real competitive edge and merely being lucky. Too many bankers consciously ignore the leverage they take on. Too many bankers do not understand risk-adjusted returns. And front running customers is endemic – on too many bank trading floors and on the floors of too many exchanges all over the world.

You will not be able to set effective limits on bank risk taking unless you understand the risks that bankers are actually taking. I do not believe that you will find those risks, or be able to contain them, unless you work backward from the returns that bankers think they are generating in their distinct risk-taking businesses.

*Giving up free options to create stable capital structures*

The second challenge you have taken on is to ensure that bank capital structures reduce the risk of taxpayers socializing losses for private risk-taking gains. This is relatively simple to conceive but hard to implement. Traders, bank executives and bank supervisors each have to give up free options they now hold.

First, I do not believe that bank capital structures can be stable, or that you can provide taxpayers with reasonable assurance, as long as traders and bankers have the opportunity of converting assets into derivative exposures and, thereby, moving to a preferred position in the capital structure.

Thirty years ago we worried that, in the event of a bank failure, open forward counterparty trading exposures would be “cherry picked” by bank receivers. This put trading counterparties in the position of having to pay the bank receiver for individual trades in which the receiver was “in the money” while being left an unsecured general creditor of the failed bank for those trades in which the counterparty was in the money – exposed to the gross rather than the net amount.

Today, trading and derivative exposures have secured for themselves – wrongly in my view – a preferential position in which their net claims on a failed counterparty are treated by the authorities as coming ahead of all other claims on the estate of the failed bank and due *prior to* and *exempt from* the bankruptcy stay. While making bilateral net exposures binding on the bank receiver makes a great deal of sense, it makes no sense for these net counterparty trading exposures to come ahead of all other claims.

This gives traders, customers and counterparties a free option to express any asset, position or exposure as a total return swap and, thereby, move up to a super preferred position in the capital structure. Whatever trading exposure a bank takes on – however large, foolhardy or lossmaking – creates a preferential claim on the banks’ assets for its counterparties. This is a dreadful mistake.

The Volcker Rule, the Vickers Commission, and the Liikanen Report are each noble efforts either to contain or to unravel this folly indirectly. My own suggestion is that we attack the problem directly. The binding net trading exposures of *all* counterparties - both bankers and their customers – should be placed back at the bottom of the capital stack as unsecured general creditors.

In addition, all open, bilateral counterparty forward trading exposures should be more than one hundred percent collateralized with high quality assets. This is what real clearinghouses do. This is what central counterparties should do if they are to be effective in reducing risk. This is what any self-respecting casino does when it requires customers to buy their chips before they sit down to play.

The second free option that needs to be removed is the option that bank executives hold – as a consequence of supervisory forbearance – to avoid raising common equity when it is most needed. In all the discussion of systemic resolution and living wills, we seem to have skipped right past the necessity of making bank management raise common equity when they breach prudential thresholds.

Let me suggest a rule: when a bank falls below the specified equity threshold it will have 90 days to raise new common equity to restore its ratio and failure to do so within 90 days will result in the bank CEO and the senior, responsible supervisor being required to submit their resignations. If we could take away management's free option – to plead for forbearance, to double down their leveraged bet on a highly-leverage balance sheet and to avoid dilution – and implement this 90-day rule, I think we would find that banks rarely enter the 90-day period.

Both bankers and bank supervisors will come up with a number of reasons why it will be difficult to carry this out in practice. I understand. My suggestion is only that we cross that bridge with a new CEO and a new senior supervisor.

When all else fails, we will need to turn to bankruptcy, systemic resolution and the living wills. A great deal of progress has been made in this area over the last few years. But I do not believe that bank capital structures will be stable, or that investors can help discipline bank behavior, unless the bank supervisors give up their free option of waiting until after the fact to explain the details of the living will and how resolution will affect different classes of creditors of the different entities within a holding company.

Senior creditors – bondholders – are ready, willing and able to write catastrophe insurance in bail-in-able debt for banks and bank holding companies. But we need to know where to price it. We need to know in which entities' liabilities we should attach a premium for the risk of systemic resolution: the holding company or the impaired operating subsidiary. If banks and bank supervisors keep too much of the living will under wraps, bondholders will not be able to price a risk premium that differentiates among the entities within a holding company or between holding companies.

At present, bondholders can only price an "ignorance premium" – we don't really know where the cost of resolution will fall. But if supervisors can reveal the "presumptive path" that resolution will take, bondholders will be able to demand a premium and that cost will – at least have a chance to – influence banks' behavior.

If each of these three options can be stripped away, the cost of bank capital – both the debt and the equity – will go down, bank capital structures will be more robust, depositors and taxpayers interests will be more secure.

If, at the same time, the supervisory process can be redirected away from the decomposed elements of risk and toward the risk-taking revenue streams inside of banks – with a clear focus on discerning how these revenues are calculated, how they are generated and how much and what kinds of risks are taken – then supervision will be engaged *both in helping bankers become better risk managers and in placing effective limits on bank risk taking.*