Lingering Prospects for US Financial Reform

Simon Johnson says that despite a push back from the financial industry, Congress is taking a close look at increasing capital requirements for banks.

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Steve Weisman: Reform of the financial system and the implementation of Dodd-Frank is lumbering along, and Simon Johnson of the Peterson Institute for International Economics is here with me, Steve Weisman, to provide an update on the progress and lack of progress. Simon, let me start by noting that, as I understand it, the financial industry is pushing back with some success on the implementation and codification of the regulations. Tell me about that.

Simon Johnson: The financial industry, the big banks in particular, have been fighting back for a long time, since 2010 or even before the legislation passed. They've had some successes in delaying implementation. There is no Volcker Rule, for example, yet, and the Federal Reserve has not yet issued some really key regulations, for example, about capital requirements for systemically important financial institutions. But I think the tide has turned. I think that the big banks are having things a bit less their own way at the moment.

Steve Weisman: Why is that?

Simon Johnson: Mostly because Senator Sherrod Brown [D-OH] and Senator David Vitter [R-LA] have cooperated on some legislation known as the Brown-Vitter Bill, which would substantially raise capital requirements. And this has got people's attention because you have a leading Democrat and a prominent Republican sharing some ideas and agreeing on a joint approach and putting capital at the center of that.

Steve Weisman: Capital should be at the center, shouldn't it?

Simon Johnson: Yes, absolutely, equity. How you fund yourself with equity versus debt? How much leverage are you allowed to have? How much debt relative to your total balance sheet? I think that should absolutely be central to anyone's thinking about the financial system.

Steve Weisman: But, you just said that the Fed was pondering implementing those parts of Dodd-Frank that called for increased capital ratios?

Simon Johnson: The capital piece actually comes more from Basel III, the international agreements that the U.S. signed up to. Dodd-Frank was relatively silent on capital. However, Basel III and Dodd-Frank have moved together and their delays in implementation absolutely have been matching up to this point.

Steve Weisman: There a kind of interrelation with the Congress or the Senate in this case moving and that it makes it easier for the Fed to be tougher. Or does it put pressure on a reluctant Fed?

Simon Johnson: It puts pressure on a Fed that has been dragging its feet in my view. Now, there is obviously a range of opinions within the Federal Reserve System, even at the Board of Governors, but the Fed has not moved quickly. And a lot of people are looking and they're saying, "Look, you passed this law three years ago, nothing much has happened, the banks seem to run their businesses in the same sort of way as they did before."

Either if you're pro-Dodd-Frank, you could say it got implemented. Or, if you're anti-Dodd-Frank, you say, "Look, this clearly wasn't sufficient." Brown and Vitter have brought both those two streams of ideas together to say, "Hey, it's time to do something additional, something new, and something that would potentially also simplify regulation, because if you fund yourself with a lot more equity relative to what you have now, perhaps we don't need all the bells and whistles of Dodd-Frank."

Steve Weisman: I remember you and others saying that capital was so important that the other regulations are secondary.

Simon Johnson: I'm not sure they're all secondary, but certainly capital equity is a central point and also increasing equity a lot more than we have increased it to date. That's really a key insight from both the financial crisis and what happened afterwards. And I think Brown-Vitter absolutely represents that. Now, we'll see how much traction it gets on the left and on the right. Does it get picked up in the House of Representatives, for example?

Steve Weisman: Any evidence of that?

Simon Johnson: I would say serious people are very interested in this approach.

Steve Weisman: Brown and Vitter are both non-establishment members of their parties. Is there any sign on the Republican side in the Senate of any senators following with Vitter?

Simon Johnson: It's still early days. I don't think that we necessarily have seen as much support as we're going to see, and my conversations with people across a whole range of political views have been encouraging, frankly. But, it's early days. And, the industry is pushing back very hard. It's one report a week basically from a major bank or one of their allies or some group that it's funding saying: there is no too big to fail; if it exists, there is no subsidy; if a subsidy exists, it's teeny and should be ignored. And so, they're pushing. Again, every single dimension that you can deny is being denied. But, to my mind, that's healthy. They are coming out in the argument. They've been forced to make these points which I and others can then attempt to take down in a similarly public forum.

Steve Weisman: Bottom line, Simon, though, is that increased capital requirements for financial institutions does or does not make them less profitable, with the end result in perhaps shrinking the financial sector.

Simon Johnson: I don't know what is the "right size" for the financial sector.

Steve Weisman: Right.

Simon Johnson: I have no idea on that. I can say that if you fund your largest banks with more equity, then the equity becomes safer as an investment and so does the debt. You have a bigger cushion against losses. The banks—or the people who run the banks—are very taken by the idea that all that matters is return on equity unadjusted for risk, but that isn't all that matters from a social perspective. If the banks show good profits for four years and blow themselves up in the fifth year on a regular basis, you should be unhappy with that in the modern American economy, and I think that is, to first approximation, the situation that we currently have.

Steve Weisman: What do the banks say when you make that argument to them?

Simon Johnson: Obviously they are not persuaded. They are rather convinced that targeting return on equity in this unadjusted way, not allowing for risk, is the only conceivable way they could run their businesses, and that's part of the technical discussion we're having.

Steve Weisman: Simon, thanks very much. Let's end there and we're going to do a part two.