Minneapolis Fed

Doubling Down on Wisdom Is an Illusory Solution

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Our financial system has required three massive government interventions in 15 years, starting with the Global Financial Crisis in 2008, followed by a near-collapse of markets in 2020 as the COVID-19 crisis erupted, and now, yet again, in 2023 when Silicon Valley Bank, Signature Bank and First Republic collapsed, triggering strains in the regional banking sector. Can't we do better as a nation?

Instead of doubling down on a complex system of rules for banks that provide the illusion of stability, we should adopt a far simpler and more effective solution: more equity capital.

For years I have argued that the largest banks remain Too Big to Fail. Recent events demonstrate that this is not only true but also worse than I realized. Depositors understand that the largest banks enjoy essentially unlimited deposit insurance, and that understanding created a systemic risk when depositors pulled funds from smaller banks that are not TBTF and sent them to the largest banks.

Dodd-Frank was supposed to have addressed these systemic risks by creating an enlightened regulatory apparatus that would carefully identify and manage risky behavior before issues arose.

But that vision was built on an assumption of wisdom. Bank management would make wise investments. Boards of directors would wisely oversee managers. And regulators and supervisors would be wise: In designing a complex system of rules tailored to meet each bank's risk profile, in designing stress test scenarios, in knowing when to escalate concerns.

But the only guarantee we have is that humans make mistakes and will continue to do so. Central bankers, including me, and most market participants, didn't see high inflation coming. Our traditional stress test models assumed rising rates were actually good for banks, because they raise deposit rates slowly so their margins go up when rates rise. Key banking regulations assumed that government bonds carried no risk.

As regulators contemplate changes in the wake of the recent banking failures, we should resist the temptation to double down on wisdom: Hiring more staff. Developing smarter stress tests that will contemplate the right shock at the right time. Designing a more enlightened, tailored regulatory framework. Instead, we should assume that managers, boards, supervisors and policymakers of the future will continue to make mistakes, as they have in the past.

We can design a regulatory system that will withstand this inevitable human failure. And that system can be far simpler than what we have today: more equity capital. We can't predict the next shock: Where will it come from? How broad will it be? Which firms will be most at risk? Sufficient capital can protect against virtually all those scenarios.

While capital levels in the banking sector are higher than they were in 2006, that tells us nothing about whether they are high enough. Numerous independent analyses have concluded that they are not high enough to balance the significant costs that financial crises have on our economy. Not on average and certainly not when one considers the variation of capital across institutions. If SVB, Signature and First Republic had significantly more equity capital, their depositors would have been reassured because the banks could have absorbed their mark-to-market losses. Higher capital levels can both address the too-big-to-fail advantage of the largest banks (which stunningly tend to have much lower levels of capital than small banks have) and can reduce the complexity of our regulatory apparatus. Complexity is not an indicator of resilience; it is an indicator of fragility, masquerading as sophistication.

Banks hate higher levels of capital because the amount of capital inversely affects their stock prices, and they will thus fight higher capital requirements with all their mighty influence.

And it will be much easier for regulators just to double down on wisdom: We'll get to avoid that fight with bankers. Instead, we'll get to update our models. Run more scenarios. Write more reports. We'll get to do a lot of things—all well intentioned—that will feel like we are making the system safer.

But we won't be addressing the underlying problem. We will be doubling down on the thing that we know fails in every crisis. Having significantly higher levels of capital is our only chance to build real resilience in our financial system.

I urge us to have the courage to take the hard path and address the underlying fragility of the banking sector. If the conclusion is that we simply can't achieve meaningful increases in capital given political constraints, and that betting on more wisdom is better than nothing, then let's tell the public that is the trade-off we are being forced to make. But before we adopt an illusory solution, I hope we aim higher.