CHAPTER 4

The Dogma of Capital Regulation as a Response to the Financial Crisis

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The reason I raise the capital issue so often is that, in a sense, it solves every problem.

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1 Introduction

Leverage is like uranium. Under perfect conditions both leverage and uranium create opportunities for economic growth and prosperity. Leverage creates profit when the cost of borrowing is lower than the return on investment. Uranium fuels nuclear power plants which support modern life without warming the planet. Under less than perfect conditions, both leverage and uranium can destroy economic gains and undermine welfare. Leverage can lead to insolvency when the cost of debt exceeds the return on investments. Uranium can end lives and destroy communities when nuclear power plants fail.

Leverage is both the life blood and the death knell of large financial institutions. Such institutions use leverage to grow, but their leverage can also lead to their demise. Reliance on financial institutions as a mechanism of economic growth is like relying on nuclear power to solve global warming. Leveraged institutions can power our recovery, like nuclear power plants could slow global warming. Yet, the risks of such solutions are very high and rely heavily on effective regulation. While recent developments, both domestically and internationally, display serious attention to the threat of highly-leveraged institutions, past experience suggests that increasingly complex regulation will lead to even more complex financial innovations designed to avoid such regulation.

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The negative externalities in financial services are significant. Among other things, the operations of the financial service industry can lead to systemic instability. Systemic instability can be described in various ways but in very general terms involves the risk of domino-like collapse and/or the risk of asset price spirals. Domino-like collapse arises when financial distress in one financial institution is communicated to other institutions. Such contagious distress may occur when the failure of one institution to settle its obligations may cause the failure of other, fundamentally sound, institutions. Alternatively, problems in one institution trigger a crisis of confidence in other institutions. More recently, attention has focused on asset price spirals. Such downward spirals can begin when one bank's need for liquidity forces it to sell assets at fire-sale prices. Such action puts downward pressure on the value of assets of other similarly situated banks which in turn reduces the capital of those other banks. If in response, for example, those banks reduce their lending, then their borrowers (i.e., other banks) will face more liquidity pressure and be forced to sell more assets at fire-sale prices, and so on.

Regulation of financial institutions is the government's primary response to the negative externalities in financial services. Concerns of systemic risk dominate the so-called prudential regulation of financial institutions which seeks to minimize the threat of systemic collapse. Such concern is understandable given the costs of systemic crisis, both in terms of lost economic output and the public funds expended in bailing out failing institutions. According to a recent report by the Federal Reserve Bank of Dallas, the Financial Crisis of 2008 (“Financial Crisis”) resulted in an output loss of somewhere between $6 and $14 trillion, reminding us again of the link between the financial sector and the real economy.

Capital regulation, which, among other things, places upper limits on financial institutions’ debt, is the primary international mechanism for regulating

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2 A negative externality arises when an economic activity generates a cost for which those engaged in the activity have not been charged. A common example of a negative externality is a factory that dumps waste into a river thereby destroying the livelihood of downstream fishermen.

3 For further discussion on domino-like collapse and asset spirals, see Heidi Mandanis Schooner and Michael W. Taylor, Global Bank Regulation: Principles and Policies (Academic Press, 2010) at 35–49.

4 Governments also respond to externalities by providing lender of last resort liquidity (through the central bank), deposit insurance, and other fiscal support.