

The Persistent, Politically-Motivated Failures of Bank Regulation and Supervision

Charles W. Calomiris

November 2025

What's been right about Trump Administration's recent bank regulatory reform?

- Eliminating politicized abuse of “reputation risk” in prudential regs
- SLR rollback (it was overkill, which I recommended eliminating when I was at the OCC; what is needed is MEANINGFUL risk-based capital regulation)
- General suspicion of Basel and wanting to Americanize it
(Basel is a corrupt conspiracy for inaction)
- MRA reform to prevent politicized abuses of supervisory discipline
- Creating charter possibility for stablecoins via Genius Act

What's been wrong about the Trump Administration's regulatory policies?

- Risk-subsidizing policies based on election cycle-driven myopia
- GSE privatization without risk discipline will lead to a repeat of Fannie & Freddie contribution to the crisis of 2007-2009
- Deposit insurance expansion (wrongly justified by TBTF – “two wrongs make a right” thinking). The finance literature has consistently shown that expanding deposit insurance increases systemic risk.
- Codifying a bad business model in Genius Act. [Story for another day]
By requiring demandability of coins and redemption, they created unnecessary potential instability.

What's wrong (Cont'd)

- Continuing Biden Administration failure to deal with weak banks that were red flagged in 2023 crisis by forcing them to recapitalize (as Amit Seru and his coauthors have shown).
- Especially troubling given the coming tariff-induced recession and the existing Commercial Real Estate losses (as much as 20% of office buildings with maturing debt this year will be have values less than debt principal).
- And the related failure to reform regulatory and supervisory framework to roll back TBTF or deal with 2023 red flags (note FER 2024 report, which recommended modernizing regulation and supervision to use economic as opposed to accounting approach to capital regulation).

Ignored Transformation of Thinking of Last 30 Years

- Market information forecasts bank condition and crisis, and can be incorporated into regulation and supervision.
1. 1997 AER Calomiris-Mason on Chicago crisis of June 1932: banks were known to be weaker than surviving banks, reflected in stock prices and interest rates paid on debt.
 2. 2005 JB Calomiris-Wilson on New York City banks in 1920-1940: market for deposits targeted a low default risk and measured that it for individual banks by using market equity values, not book values.
 3. 2012 JACF Calomiris-Herring: individual big bank's economic equity declines in 2006-2007 predicted their own losses in 2008-2009 when economic equity hit critical low value (about 2%) that made it impossible for them to rollover their uninsured debts, leading to crisis. Same was true individual European banks.

Was the 2008-2009 Bank Collapse a Surprise?

- No, a 90-day backward looking moving average of the economic (market) value of equity/ economic value of assets showed persistent decline for nearly two years. If you were tracking this you knew that the summer of 2008 was a tinder box.
- When each bank got to a threshold of ~2% market equity ratio, it became unable to roll over its debts and failed.
- Not all banks got to that threshold. Wells Fargo did not. JPM did not. BofA and Citi did.
- Why didn't regulators use a market equity ratio "thermostat" to force banks to recapitalize to a safe level in the spring/summer of 2008.
- Perhaps because you cannot **manage** what you don't **measure**. They were looking at book values. In Dec 2008, Citi's Basel ratio was 12%.

Figure 4 The Ratio of the Market Cap to the Quasi-Market Value of Assets for Ten Banks That Required Substantial Government Intervention, April 2006–April 2010

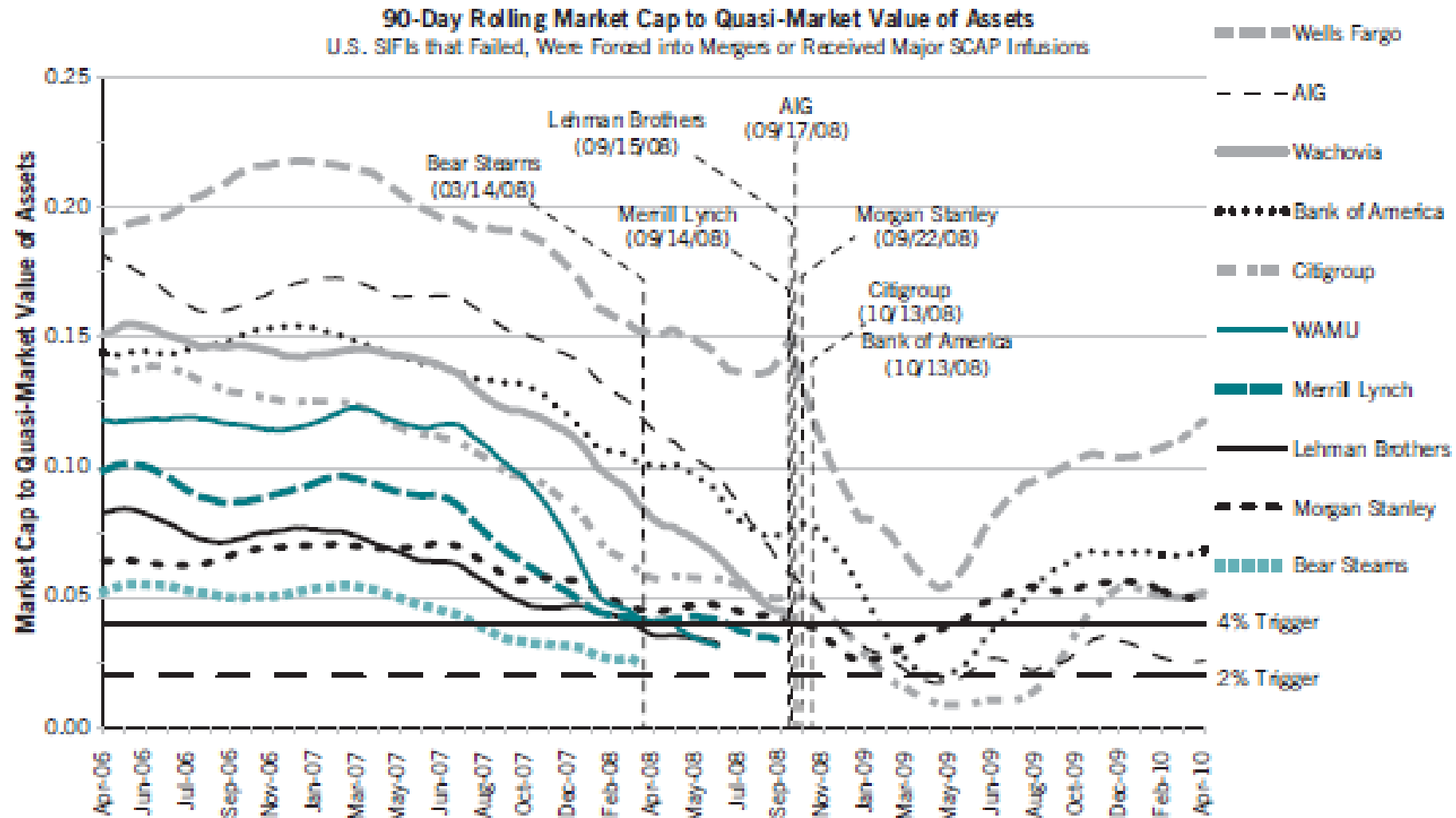
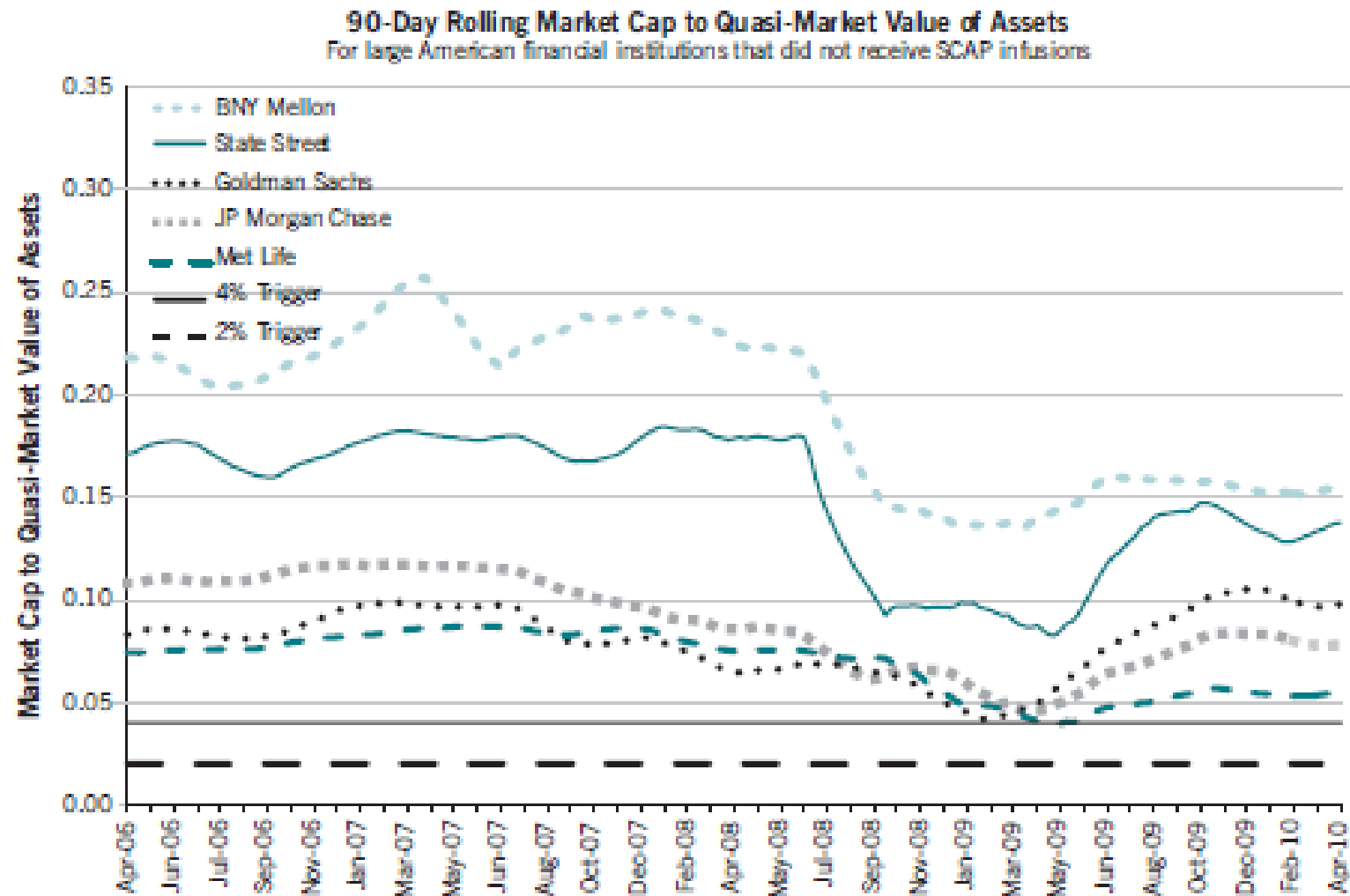


Figure 3 Ratio of the Market Cap to the Quasi-Market Value of Assets for the Five SIFIs That Did Not Require Substantial Government Intervention, April 2006–April 2010



Market-to-book ratios of large US banks (**June 2017**) show that we continue to use capital regulation, including stress tests (based on book value as criterion of success) to tax good banks and subsidize bad ones.

US Bancorp	2.11
TD	1.73
M&T Bank	1.67
Wells Fargo	1.51
BONY Mellon	1.43
PNC Bank	1.43
JPM Chase	1.34
BB&T Bank	1.33
Morgan Stanley	1.20
Goldman Sachs	1.20
Bank of America	0.98 Negative intangible assets
Citigroup	0.85 Negative intangible assets
Capital One	0.80 Negative intangible assets

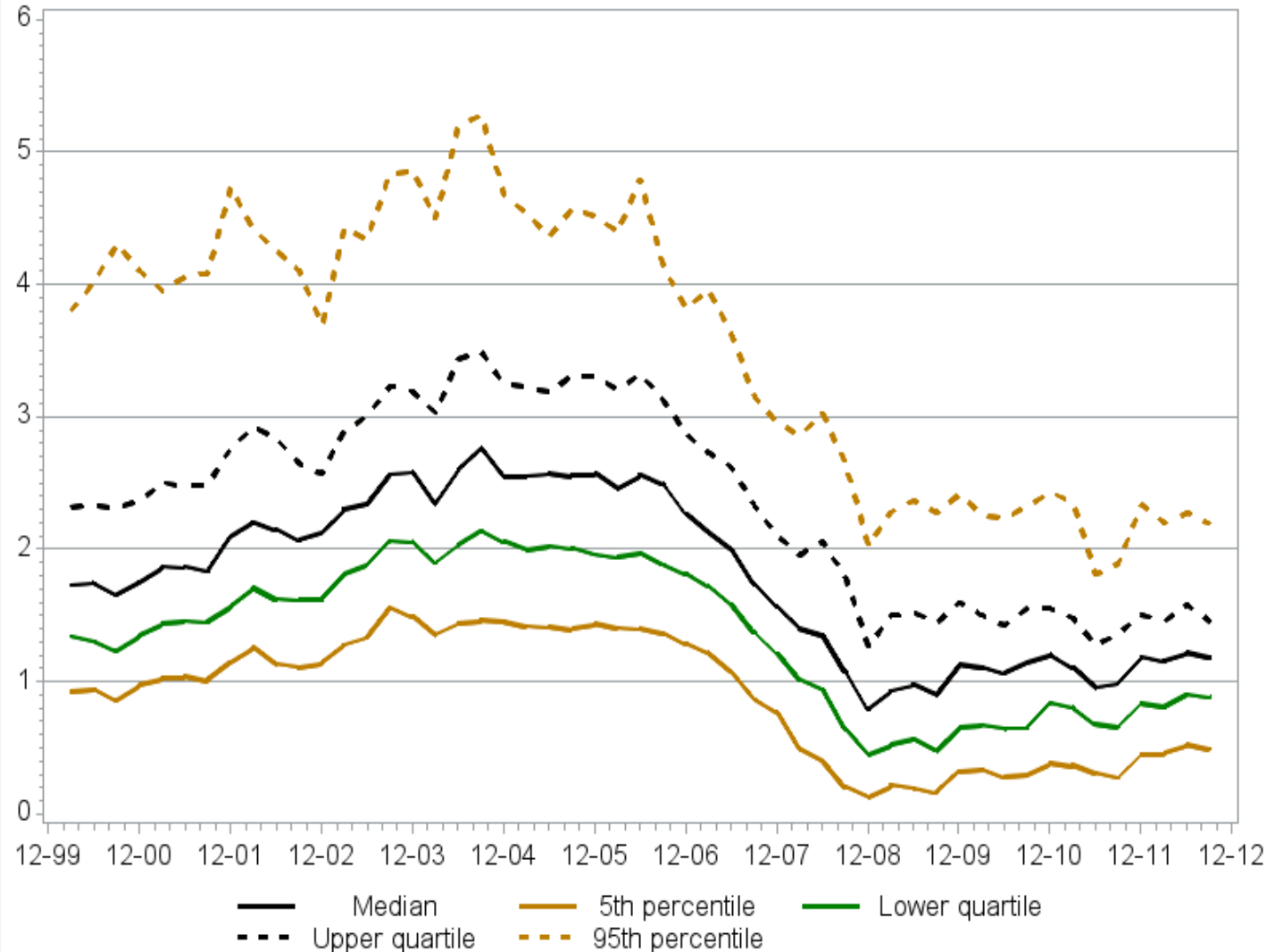
SRISK Model is Based on Same Thinking

- SRISK model developed at NYU's Stern School, which takes the distance-from-trigger measure a step farther.
- Here the question is whether the MVE/MVA is large enough to withstand a big shock. A big shock (30% equity decline for S&P) may have different effects on bank MVE, depending on each bank's beta. So their model takes that into account. (Using data from 3/1/20 to 10/21/20 betas are: JPM = 1.3, BAC=1.4, WF=1.4, C=1.9).
- Adequate capital for them is enough so that when the big shock hits your bank remains above the distress threshold.
- **Conclusion: A 30% shock to the S&P would result in C stock falling 57%, which would take MVE/MVA to below its distress threshold.**
- Note that this is quite similar to Black-Scholes-Merton (sigma and beta are positively correlated by construction; higher RF/TL makes beta and sigma lower, for example).

Ignored Transformation (Cont'D)

1. Calomiris and Nissim 2014 JFI showed that you can use bank cash flows and balance sheets together to decompose value-creating contributions to bank equity values that capture *intangible assets'* contributions to capital. (Bank equity values are closely linked to the observable successes or failures of business strategies.)
2. Matthew Baron's 2021 QJE paper showed that equity declines of banks produce major credit contractions and banking panics, corroborating prior research showing that historical banking panics have fundamental causes. Other work by Matt and coauthors showing that persistent declines in bank credit are forecasted by declines in market equity value.

MVE/BVE Shows Huge Variation Across Banks



What Can the OCC Do?

- Add MVE/MVA as a key indicator for NRC early warning suite.
- As we near the trigger of concern, use supervisory discretion to require more capital.
- Employ in countercyclical capital buffer dashboard and conversation with Fed.
- Work with LBS/Midsize EICs (and others where observable bank valuations exist) to deepen conversations with bank management.
- Improve the current prudential framework to incorporate this thinking, and make this part of an interagency discussion of long-run reforms to capital standards. (December 11 conference may be a good entry point.)

CoCos Advocated by Flannery, Calomiris-Herring, Goodhart, and many others

- CoCo requirements (triggered long before insolvency, not bail-in CoCos) make capital requirements smarter (using market info); or use equity values, cash flows, and other information to track changes in the economic value of banks and make that part of capital requirements.
- OCC team of 30 economists developed system to measure economic equity and failure risk using three approaches, but regulators and supervisors (people who could not even define a standard deviation if their lives depended on it) were uninterested in pursuing that. They prefer (as we saw in 2023) to rely on discredited book values and use check-the-box standards (based on “brown rat” dog-eared handbook).
- **Deeper problem: political influence prevents real discipline!**

Here Are Some Slides I Used
at the OCC to Explain the
Framework We Developed

How should we think about capital?

- Book value of assets almost useless as a starting point for thinking about the value, or even the size, of the entity.
- Valuation approaches from finance are useful
 - Discounted Cashflow (DCF) based on free cash flows
 - Multiples approach based on peers
 - Implied asset value changes (market values)
- With valuation as a starting point, one can then estimate appropriate regulatory limits on leverage.
- Additional analyses: securitization risk transfer, operational risk

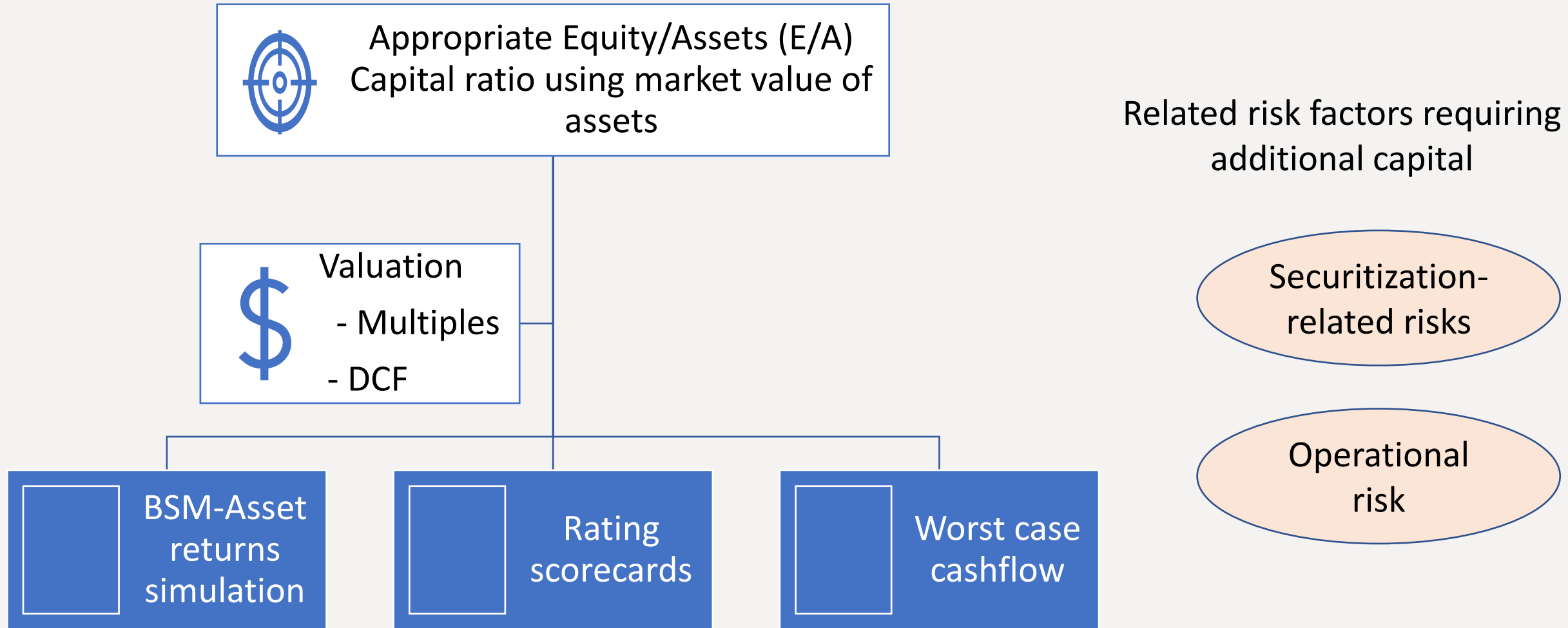
Alternate metrics consistent with goal of appropriate limits on leverage

One can conceive of the goal as:

1. Achieving a particular level of low default risk: e.g., solvency over next two years with 99.5% probability.
2. Alternatively, the goal could be expressed as achieving a given bond rating (e.g., BBB+ or A-).
3. Alternatively, it could also be expressed as protecting against failure risk in a “reasonable worst case scenario” of cash flows (again, perhaps a 99.5% chance of paying debt service).

Each alternative is associated with a methodology, perhaps more than one, but all strive to achieve the same goal.

Capital framework and approaches



Conclusions

- I fear that the combination of Fannie and Freddie privatization, and failure to discipline banks with credible regulation and supervision, both the consequence of politically-driven myopia that wants to goose up credit supply, will set the stage for a major financial crisis, or perhaps more than one (commercial real estate/banking crisis within a year or two, and a housing crisis in the medium term).
- Then politicians will wring their hands, blame market failure, and bail everyone out again.
- Is this really the best we can do?