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Keep It Simple

By JOE NOCERA

What if Jamie Dimon is right?

What if the chief executive of JPMorgan Chase is not just blowing smoke when he complains that the country — and, indeed, the world — has imposed so many new rules on the banking industry, some of them overlapping, others seeming to contradict each other, yet others whose sole purpose seems to be to weigh down the industry, that they threaten to do as much harm as good? Last summer, you'll recall, Dimon confronted Ben Bernanke, the Federal Reserve chairman, at a conference and asked him: "Has anyone bothered to study the cumulative effect of these things?" Just last week, during JPMorgan's earnings call with analysts, Dimon complained that Europe's "regulatory policy, government policy, central bank policy — it's not coordinated. It's making the situation worse, not better."

Like most nonbankers, I've tended to roll my eyes at Dimon's continuous lamentations. Surely, given all the harm the banks did to the country, regulations aimed at preventing a repeat of the financial crisis struck me as being worth whatever cost they imposed on the industry. And, yes, I admit to a little schadenfreude as well. (To be fair to Dimon, he is not completely opposed to all the new regulations. He just comes across that way when he's in rant mode.)

What has caught me up short recently is the emergence of a new critic of the banking regulations that have been pouring forth from Washington and Europe. Her name is Karen Petrou, and she is the managing partner of Federal Financial Analytics, a consulting firm that, among other things, analyzes bank regulations for clients.

Unlike many in the banking industry, Petrou is not ideologically opposed to regulation. For instance, she was a critic of the lack of regulation that allowed so many sleazy subprime mortgage originators to emerge from the precrisis ooze. Yet, now, she's worried about something different: that the hundreds of new mandates required by the Dodd-Frank law are creating a new kind of risk. She calls it "complexity risk." As she put it in a speech she delivered last week in New York: "If we don't understand the cross-cutting effects and inherent contradictions in all of the stringent standards now being written into final form, we risk doing real damage to the sound, stable and — yes — profitable financial industry regulators say they support and the economies sorely need."

In a paper she wrote in November, Petrou laid out a number of examples of new regulatory proposals that were either mind-bogglingly complex or contradictory — or both. For instance, she told me recently, bank board directors will have 184 more things they will have to acknowledge responsibility for under the latest systemic standards. "I think boards have to be responsible for what happens at their institutions," she said, "but requiring them to be on the front lines of forward-looking cash flow is ridiculous."

She also points to a contradiction in the way the Too Big to Fail institutions are being dealt with. On the one hand, Dodd-Frank is very clear that if a big bank becomes insolvent, there can be no taxpayer bailout. It must be wound down, just like any other bank. Yet, at the same time, she says, the federal and international regulators are adding a host of special Too Big to Fail capital requirements and rules. “They are acting as if these institutions are still too big to fail. The two thrusts are incompatible.”

Why does complexity risk matter? One reason is that the more complex the rules are, the greater the likelihood that smart bankers will find ways to game them. Another is that contradictory regulations, however well meaning, simply don’t make the system safer. But the most important reason is that complexity risk is having an effect on business — and that’s not helping the still-fragile economy.

Petrou says that in her own practice she has seen deals fall through — especially in the mortgage industry — because nobody can figure out how the new rules will be applied. Given how badly the country needs a revived housing industry, this is nothing short of tragic.

In her paper, Petrou offers a series of solutions, revolving around simpler regulations, a reliance on market discipline and transparency. She also calls for the regulators themselves to be held accountable, something that is nowhere to be found in Dodd-Frank, despite their obvious shortcomings in the years leading to the financial crisis.

However you feel about banks — and I know that many people harbor enormous, justifiable anger at what they did — our economy can’t function without them. And they needed to be regulated. But three years ago, overly complex securities were one of the root causes of the crisis. So why, then, do we have faith that overly complex regulations will prevent the next crisis? Sad but true: they won’t.