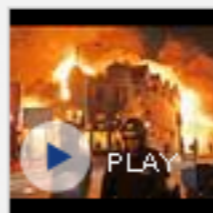


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# S&P and the 'Regulator's Dilemma'

New research shows the benefit of more than one road to bank safety.

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The Senate Banking Committee is examining Standard & Poor's decision to downgrade long-term U.S. debt, but here is the great irony of Washington's scrutiny: S&P's judgments carry such weight because Washington told the markets to pay attention to them. Federal regulators have embedded credit ratings into countless financial rules.

Naturally, the Washington crowd exempted Treasury debt from these rules, so the downgrade of America's credit rating is mainly a psychological blow and not a trigger for asset sales or capital raising by institutions holding U.S. bonds. But a critical ingredient in the 2008 financial crisis was the encouragement that regulators gave banks to hold mortgage-backed securities rated highly by S&P, Moody's and Fitch—the government-created oligopoly of credit judges.

A rare beneficial provision in last year's Dodd-Frank law instructed the bureaucrats to cut references to credit ratings out of their rules. Bank regulators have been resisting, because they are struggling to devise a better standard for judging the safety of an asset. But as counterintuitive as it may be to politicians, having no federal standard for risk is the best standard of all.

A new study by researchers at Harvard, Oxford, Cambridge and elsewhere examines the "regulator's dilemma" in attempting to minimize risk: Should the bureaucrats try to make each individual bank as safe as it can be, or focus instead on the safety of the financial system as a whole? These goals are often in conflict. The new research, published in the Proceedings of the National Academy of Sciences, finds that if we want a sturdy financial system, individual institutions should pursue different ways of achieving safety.

Here's the problem: Even if regulators can create a great recipe with the perfect mix of diverse assets and liabilities to make a safe bank, they shouldn't replicate it throughout the system. That's because every bank would then have the same vulnerabilities. Even if the chances are extremely remote that the chosen model would fail in a crisis, in such a case this "uniform diversification" would cause all the banks to fail simultaneously.

This was exactly the problem in 2008. With encouragement from regulators and their anointed ratings agencies, virtually all the banks bet big on the same types of mortgage-backed securities. Academics call this behavior "asset-herding," where all the regulated entities adopt virtually the same exposures.

The authors report that if we want to minimize risks to the entire financial system, a better model is "diverse diversification." Even if some of the banks don't have the ideal mix of assets, the overall system is stronger because bank risks are less correlated with each other. The banks, like species in nature, are saved from extinction by a variety of forms to respond to "fluctuating environments and emergent threats."

This doesn't compute for bank regulators who want one standard to impose on everybody. And we certainly understand the impulse to apply a common set of rules across the industry, especially when it's an industry that gets to play with a taxpayer backstop.

But that federal safety net is a reminder that protecting taxpayers is job one. And the latest research suggests that this job is best achieved by replacing the disastrous credit-ratings standard with no single standard other than accountability for the bank executives and investors who fail.

That last conclusion is ours. Here's how the study authors put it: "The societal costs of dealing with bank failures grow disproportionately with the numbers that fail. Hence, the regulator may wish to give banks incentives to adopt differentiated strategies of diversification."

Regulators can start on this path by replacing the credit-ratings standard with a reasonable menu of ways to judge the riskiness of assets. What they must not do is encourage banks once again to pile into assets marked AAA by Standard & Poor's or whatever new oracle Washington is tempted to trust.

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