Financial Regulation after the GFC[*]

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Introduction

Hopefully, ideally, the regulatory reform agenda, both internationally and locally, following the GFC will reflect three factors:

- a considered assessment of regulatory and market failings responsible for the crisis,
- those factors which created difficulties in dealing with the crisis, and
- unwinding and/or refining the myriad of regulatory interventions made in the wake of the crisis.

There is, already, a plethora of international and national working groups, reviews, committees considering what changes might be required, and the recent G20 Finance Ministers Meeting of 5 September 2009 provides an overview of areas of activity.

Even though there is much questioning of the dominant theoretical paradigms which guided pre-GFC regulation, such as Efficient Markets Theory and modern Macroeconomics[1], there seems to be little enthusiasm for radical change to the standard rationale for regulation. That rationale, where a necessary, but not sufficient condition, for regulation requires identification of market failures (information deficiencies, excessive market power, externalities or public good features) seems strongly entrenched in developed western economies – although the GFC has reduced whatever enthusiasm there was for this approach in many developing countries. And in the developed economies, "re-regulators" have arguably missed their chance to strike at the "mega-bankers" while they were on their knees and less able to mount an effective opposition to policies counter to their private interests.

Indeed, if there is one major lesson to be learned from the policy and regulatory responses to the GFC it is that the old adage of "socializing the losses and privatizing the gains" is alive and well, and the resulting moral hazard and adverse competition effects are among the most important issues to be dealt with in designing future regulation. Who, for example, will ever believe that a government will allow a major commercial bank/systemically important financial institution to fail and uninsured depositors (or perhaps even other counterparties) to lose money? Australia may have largely avoided explicit taxpayer subsidization, perhaps because we have had a clear demarcation between prudentially regulated and other financial institutions, but there undoubtedly implicit subsidies operating through the pricing of the guarantee scheme.

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[1] See for example, The Economist 'Briefing The state of economics.' The Economist, v392, no 8640, July 18 2009, pp.58 – 62, and the response by Robert Lucas 'Economics focus: In defence of the dismal science' The Economist, v392, no 8643, August 8 2009, pp. 63.

In what follows, the possibilities for future financial regulation are considered after first reviewing the GFC causes, policy problems and responses which should drive that future regulation.

Causes of the GFC

There is widespread agreement on the market and regulatory failures which contributed causally to the GFC, although the apportioning of blame is a matter for ongoing debate and research. Four factors can be identified as creating the conditions which led to the onset of the crisis and three factors as contributing to difficulties in dealing with the crisis.

First among the causal factors were failures in macroeconomic policies which led to ongoing global imbalances, excess liquidity creation and asset price inflation – reflected in house price inflation, a stock market boom, and narrowing credit spreads faced by borrowers. In the US, policies to foster home ownership also played an important role.

That excessive liquidity creation involved an explosion in the use of collateralized (or secured) borrowing, whereby financial assets were purchased by institutions such as investment banks and others under repurchase agreements or other margin loan type facilities. When asset prices fell and the value of the loan collateral declined, lenders made margin calls forcing borrowers to sell assets into a declining market – further aggravating downward price pressures. A number of recent academic papers[2] have pointed to increased collateral demands by counterparties to dealer/investment banks under repo arrangements or swap and other derivative transactions as the modern equivalent of a "bank run".

This experience was one manifestation of the second widely recognized causal factor – that of failings in risk management and corporate governance. In this specific example, highly leveraged portfolios were constructed in the belief that assets could be easily sold to generate liquidity. More generally, many organizations "outsourced" due diligence under inadequate incentive structures, and had remuneration policies which rewarded excessive risk taking.

Poor governance facilitated the third causal factor – the development and distribution of complex financial products with risk characteristics which both investors and originators did not fully understand.

The fourth causal factor was breakdowns in supervision and regulation. The Basel 1 Accord did not prevent the explosion of off-balance-sheet leverage and there is some evidence that the planned changes to regulatory risk-weights in Basel II contributed to the explosion in housing finance availability. It is also clear that the lynch-pins of the Basel

[2] Metrick, Andrew and Gorton, Gary B.,Haircuts (August 11, 2009). Yale ICF Working Paper No. 09-15. Available at SSRN: http://ssrn.com/abstract=1447438
Duffie, Darrell ,The Failure Mechanics of Dealer Banks (June 22, 2009). Rock Center for Corporate Governance at Stanford University Working Paper No. 59. Available at SSRN: http://ssrn.com/abstract=1439908

II, Pillar One, capital requirements, which are bank internal risk models and ratings by CRAs, did not perform well.

There are thus plenty of candidates available for attribution of the blame.

Regulatory Responses and Problems in Dealing with the GFC
There are also factors to be considered in causing problems in dealing with the crisis. There is no doubt that the policy response was one of "belts and braces" – reflecting the uncertainties about what the true nature of the problems were and whether particular policy responses would work well – if at all – in resolving the problems. For example, it has been argued internationally that initial policy responses were based on a miss-assessment that the problem was essentially one of illiquidity rather than one of solvency – although the two are, of course, inextricably intertwined. Thus we saw a myriad of:

- actions to unfreeze and/or restore liquidity to asset markets and financial institutions
- policies to shore up public confidence in national banking sectors
- actions to deal with failing institutions including "bail outs" of systemically important non-bank financial institutions, partial nationalizations of banks, and arranged/forced mergers and takeovers
- temporary regulations on financial markets and institutions (such as short-selling bans)
- macro-economic policy stimuli
- regulatory forbearance (back-tracking on mark to market/fair-value accounting?)

The future regulatory reform agenda needs to encompass the winding back of some of these actions and finding ways to deal with the longer-lasting incentive and expectations effects (most prominent in the discussion of "too-big-to-fail" institutions) as well as addressing the causes of the failure and problems in dealing with it.

What were the factors which caused problems in dealing with the crisis? Perhaps one of the most important ones was a lack of knowledge about where risk resided in the system. Faced with a lack of transparency and opaqueness about financial institution solvency and interdependencies among institutions, counterparties became unwilling to transact with each other, and regulatory authorities were unable to easily assess how policy actions – such as allowing failure – would operate.

A second important problem arose from the inconsistency created by <u>national</u> regulatory agencies and <u>multinational</u> financial institutions. Actions taken by national regulators regarding a troubled institution in their domain have implications for its subsidiaries and branches and customers and counterparties in other domains.

A third problem was inadequacies in some parts of liquidity management and lender of last resort arrangements. In particular, as the Northern Rock experience in the UK starkly demonstrates, any hint that a financial institution is utilizing emergency lending facilities may be enough to generate concerns that it is insolvent (and lead to that outcome) rather than just illiquid.

The Reform Agenda

The G20 Finance Ministers' *Progress Report* of 5 Sept 2009[3] provides an overview of what is underway. There are ninety-two headings in the action plan. Ten relate to keeping the world economy functioning and thirty four relate to governance and resourcing of international financial institutions (IMF, World Bank etc.) and international cooperation. Eight relate to dealing with tax havens etc. Sixteen address prudential regulation and nine address the scope of regulation. Accounting standards get eight headings, credit ratings agencies get three as does compensation.

Apart from one item requesting all countries to submit to FSAPs which review the effectiveness of regulatory systems, there is nothing about incentive structures for, and organization of, national financial regulatory agencies. This is a major omission, despite the general agreement that there were failings in national supervisory regimes, and strange given the significant attention paid to governance reforms of IFI's and compensation in financial institutions.

Under the topics of prudential regulation and the scope of regulation there are many technical issues, such as Basel II amendments, being addressed. But is the "big picture", within which those issues are being considered adequately painted, and leading to the right focus. I think not.

Consider, for example, the role of *limited liability*. The introduction of this concept has contributed greatly to world economic development and growth – but it has also enabled the finance sector, in the pursuit of private benefits, to undertake activities and expand beyond the realm of what might be perceived as socially valuable. For financial institutions, the concept is relevant both for decision-making agents within those institutions and for the owners and other stakeholders in those institutions.

Take the current focus on remuneration levels and risk-taking incentives. It is all about the upside payoffs, not the downside. The problem faced in financial institutions can be summarized in four points (a) managers have option like remuneration payoffs (lots of upside and limited downside); (b) options increase in value as volatility increases; (c) managers have the ability to increase the volatility affecting their payoff; (d) managers/traders are given enormous financial leverage in their position taking relative to their own wealth.

So, what is the conclusion from this? Perhaps the focus should be more on influencing decision-making by increasing the downside personal risk and limiting the leverage which individual decision-makers in financial institutions can utilise, rather than on trying to limit the upside. Because, realistically, trying to limit the upside of remuneration isn't going to work. We know how innovative finance executives and their advisers are in finding ways around regulation of their firms which impact only *indirectly* on their hip-

[3] http://www.g20.org/Documents/20090905_G20_progress_update_London_Fin_Mins_final.pdf

pocket or purse. Imagine how innovative they will be when dealing with regulations which *directly* affect their hip-pocket or purse.

This line of thought links back more generally to the level of the organization and its structure and funding. Once upon a time, a long time ago, there were common examples of bank owners having double or unlimited liability and until 1970 (in the US at least) investment banks were partnerships. Owners had liabilities which were illiquid stakes in the organization which undoubtedly helped concentrate the mind about risk taking and governance arrangements.

I doubt we can (or should) return to those specific types of arrangements. But one topic which should get more consideration by international regulators is the concept of a requirement for some level of *contingent capital*. There are a number of proposals which have been suggested, but essentially they involve having some stakeholders whose investments will mandatorily convert to equity (or where they will be called to inject additional equity funds) under certain pre-specified circumstances. Some variant of callable bonds and partly paid shares are examples (as is the proposal to abolish deposit insurance and have a depositor "haircut" scheme which the New Zealanders toyed with). As well as providing additional equity when needed, having such liabilities on issue must work to enhance market discipline and governance – perhaps more so than the frequently proposed (by academics), and ignored (by regulators) case for mandatory subordinated bond issuance by banks. That governance role could be enhanced by assigning some form of superior voting rights to such contingent capital instruments.

Note that requiring "contingent capital" is different from the current emphasis on strengthening capital, mitigating procyclicality, building capital buffers, allowing provisioning for "expected loss" etc. It is important to remember that capital is nothing more than the residual difference between the value of assets and other liabilities. These measures make that gap, measured somehow, larger, but do not help in dealing with crisis situations in which the gap shrinks dramatically.

What is fascinating in all of this discussion is the effective abandoning of some fundamental precepts of international agreements and accords which have dominated the recent years. Consider risk based capital requirements. The Basel Committee is examining the development of a "simple leverage ratio" (good luck on that!) as an "adjunct" to the risk based capital requirements which have driven massive bank expenditures on risk management systems in recent years. The US has long operated a simple leverage ratio (of five per cent) as well as the Basel I requirement and, in general, that has been the effective constraint on bank behavior. As another example, consider International Accounting Standards, where mark-to-market/model requirements have been seen by many as contributing to some of the recent problems.

Yes, it makes sense to account for financial instruments at "fair value" – but based on whose information and valuation – that of a disorderly market or a valuation based on private information of a bank which intends to hold the asset to maturity and believes that its value on that basis is unimpeded. Requiring disclosure based on a disorderly market valuation may prompt the very event of depositor withdrawals, forced sale of the asset at losses and ultimately failure of the institution. Of course, we may not always trust the private valuation, but where the socially valuable product of liquidity creation is based on confidence, we need to be careful about what information set is used in determining asset values.

A second feature of the "big picture" which is perhaps not getting the attention or publicity it deserves is that of how to deal with the *modern bank run*. In general, we thought we had resolved that problem (at least until the Northern Rock experience) by deposit insurance removing retail depositor incentives to run, and lender of last resort arrangements enabling solvent institutions to deal with temporary liquidity crises.

The problem now is inherently different and arises from the financing arrangements of large financial institutions operating in wholesale markets using collateralized funding techniques (such as repos), raising short and long term debt finance, and dealing and making markets in a wide range of securities and derivatives. For such "banks" a "run" will involve counterparties doing such things as (a) making margin calls in response to a decline in the perceived value of collateral (b) recalling or not rolling over short term funding (c) not subscribing to new issues of debt securities. The interrelationships within the wholesale financial markets, and its opacity and lack of transparency, make for a potentially very fragile network.

Andy Haldane of the Bank of England provides a very interesting "network based" approach to considering the financial system, noting that stability is inherently dependent upon features such as connectivity, feedback, uncertainty, and innovation.[4] Proposals to identify and monitor systemically important institutions, and gather more information about counterparty exposures and about non-regulated institutions (such as hedge funds), are all relevant for a better understanding of the nature of the network. But this leaves us well short of solutions, which may require special regulation of the most systemically important institutions, or altering the structure of the network. Establishing Central Clearing Counterparty arrangements, to the extent that they can work (given incentives for financial institutions to develop non-standard products which can't be easily handled by CCCPs) is one small step down this road. But it may be that enforced structural change (such as separating "utility" and "casino" banking) is important also.

Thinking about what institutional/organizational structures should be permitted /prohibited or encouraged/discouraged is also important for dealing with what is possibly the biggest problem in modern financial systems – that of implied guarantees of large financial institutions or more generally the consequences of a government provided "safety net". The safety net, designed to provide protection for some customers of financial institutions and to prevent adverse system wide effects of failure, endow certain institutions with substantial benefits which they can leverage beyond the areas originally designed to be protected. There are undoubtedly private benefits associated with scale and scope in financial institutions, but whether the social cost-benefit calculus gives the same answer as a private calculation warrants more attention. The privileges of limited

[4] Andy Haldane (2009) "Rethinking the Financial Network" Bank of England, April 2009.

liability and government safety net need to be taken into account in assessing self-interest based arguments against government interference with a free market in financial services – although determining what is the optimal shape and scale of any such interference is another, more difficult, question.

What else is missing from the global discussion? There is very little focus at the G20 level on the ultimate consumers of financial products (households and business) and whether regulation of the financial sector is failing to adequately protect them. Given the origins of the GFC in the US sub-prime market, and the numerous instances of investors being sold unsuitable financial products – this seems to be a significant omission. Consumer financial sophistication/knowledge is no match for the (designed) complexity of financial products.

But it may reflect more the specific focus of the G20 Finance Ministers, rather than an absence of action. In Australia, we have significant regulatory change underway (including suggestions for rethinking financial consumer protection by ASIC in its submission to the Parliamentary Inquiry). Internationally there is the new EU Directive on Credit Agreements, a UK White Paper foreshadowing a Consumer Rights Bill, and a Draft Consumer Financial Protection Agency Act in the USA. Common themes include increased emphasis on financial literacy programs, requiring responsible lending practices and greater transparency of financial contracts as well as the allocation of regulatory responsibilities. In Australia, the balance between *caveat emptor* and consumer protection, duties of financial advisers and their remuneration arrangements are critical issues, particularly given the inter-linkages between large producers of financial products and the financial advice industry.

Will we see major regulatory changes rather than tinkering around the edges? Probably not in the short term given the political influence of large financial institutions and ability to impede changes adverse to their private interest, and a focus on identified failings of the current system rather than broader thinking about what an optimal financial system might look like. Of course, we are constrained by what history has left us with, and starting from scratch is not an option. But the history of the last two years has left us with many issues which do involve some major thought and analysis. How to achieve a competitive, innovative, and efficient financial sector in a world where implicit government guarantees abound is, even more than previously, the major question.