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Rethinking Financial Regulation

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ABSTRACT

How could the crash of one segment of the US finance market drag the world into a crisis with such far-reaching effects? And how could the crisis spread to the entire world finance system and to the real economy? Could it have been avoided? Economists and policy-makers the world over have been pondering these questions in recent months, and will probably continue to do so for a long time to come. In a conference entitled Back from the Brink: Rethinking Financial Regulation held at the Fondazione Eni Enrico Mattei on 27 March 2009, some of the most authoritative international experts, jurists and economists sought to understand what lessons could be learnt from the crisis to improve the regulation of financial markets. This article summarises some of the ideas that emerged from the meeting.

Introduction

When the OECD announces that 20 million jobs are at risk over the next two years because of the current financial crisis, you immediately wonder how on earth this could happen so suddenly. The word "subprime" meant nothing to most people until two years ago. How could the crash of one segment of the US finance market drag the world into a crisis with such far-reaching effects? And how could the crisis spread to the entire world finance system, and to the real economy? Could it have been avoided? Economists and policy-makers the world over have been pondering these questions in recent months, and will probably continue to do so for a long time to come. In a conference entitled Back from the Brink: Rethinking Financial Regulation, held at the Fondazione Eni Enrico Mattei on 27 March 2009, organised with Bocconi University's Paolo Baffi Centre, some of the most authoritative international experts, jurists and economists sought to understand what lessons could be learnt from the crisis to improve the regulation of financial markets, starting with the banks.

Many occasionally divergent ideas were formulated during the workshop – hardly surprising, given the difficult subject and the variety of institutions and participants involved. It is very difficult – if not impossible – to give an exhaustive account of the complex and often animated debate in a whole day of work. However, the discussions did see the emergence of a consensus on the diagnosis of the crisis, and on some priorities for the design of new regulations, and we will attempt to summarise them in this note.

One fundamental point that emerged from the meeting was that the solution to the bank problem is a prerequisite for the solution to the crisis. In this sense the current dispute on the priority to give to fiscal stimulus initiatives, as opposed to new finance regulations, underestimates the fact that these measures need to proceed in parallel: it is, in fact, unlikely that increasing public spending could be effective if it is not accompanied by measures to resolve the credit crunch. We should recall that the last major financial crisis that originated in the United States, the crisis created by the dot-com bubble, had no real consequences, primarily because the banks had no "toxic" securities on their balance sheets, and so credit continued to flow as normal, and the economy emerged from the crisis.

But in the current situation the crash in securities linked to subprime mortgages reduced the value of the assets of the many banks that had strong exposure to these securities. In order to respect the capitalisation ratios set by prudent regulation, the banks, in theory, had two strategies open to them: to increase their own capital, or to reduce the assets on their balance sheets. The first route was quickly found to be impassable. Lack of transparency in bank balance sheets meant that investors were not able to evaluate their exposure to these "toxic" assets. In the absence of adequate information, no investor is prepared to risk their capital in shares of doubtful value. And even if the information problems are ignored, an injection of new capital would have primarily benefited bond holders and holders of senior debt. In fact, these securities are worth very little when a business fails, and an injection of capital increases their value by making failure less likely. These elements blocked the possibility of recapitalising the banks, which were left with a single option: deleveraging, that is, reducing indebtedness by selling assets on the market. But selling assets may be a practical route for a single bank, whereas when the whole of the banking sector tries to follow the same route at the same time, the value of the assets falls so low that the strategy becomes totally ineffective. With both of the only exit routes closed, only public intervention could save the banking sector, and that is what happened.

It emerged from the workshop that part of the cause of the crisis was institutional: inadequate regulation. In designing regulatory systems, no attention was paid to how regulation would influence the system and, in particular, what would happen if the regulatory requisites were not respected. So the crisis led to the failure of the traditional approach to bank regulation, which now needs to be completely rethought. Three guiding principles for change emerged from the discussion.

From micro to macro: towards more prudential regulation

It has become clear in recent months that, faced with the loss of assets, made even more evident by fair value-based accounting, the banks did not have enough of their own capital to cover these losses. Regulation led to an insufficient level of own capital. The amendment of the Basel I agreements introduced in 1996, and the new Basel II agreements, allowed the banks to reduce the proportion of own capital to 2-3% of their non risk-weighted assets. It is precisely the greater reliance on leverage that led the banking industry to have a ROE, or yield on own capital, of 25%. At such low levels of capitalisation, every negative impact on its assets risks compromising the solvency of a bank, and this creates formidable obstacles to its refinancing on the market.

Using equity coefficients as a tool for prudential regulation may not be a bad idea at the individual bank level. But such a tool risks being detrimental to the system. In other words, what may be desirable at the micro level may not be desirable at the macro level. In fact, if banks are forced to sell some of their assets to maintain their equity coefficients, this decreases the value of the assets of the other banks, obliging them to also restore their equity coefficients by seeking to sell assets, thus fuelling a negative spiral. So capitalisation margins must be increased during booms to be able to reduce them in periods of crisis. Alternatively, the banks could be asked to sign up to an insurance scheme that would then allow them to access capital in crises of liquidity or when access to the market is difficult. In any event, the lesson is to provide incentives for the banks to allocate resources in good periods to be able to have room for manoeuvre in bad ones, activating automatic "alarm" systems, to stop system crises before they start, insofar as this is possible.

Using equity coefficients as cushions against excessively risky investments in the banking industry has proved to have another serious limitation. On the one hand, the banks have made much of the fact that they have greater knowledge than a regulator or any other external party of the risks involved in their activities, and this has opened the way to the abuse of equity coefficients. And on the other, the risk models did not in any way include correlations with the risks run by the other parties nor, more generally, did they take the systemic risk into account. Regulation should, however, have the aim of preventing accounting manipulations and giving room for the authorities to manoeuvre, including when the whole sector is in crisis. The concept of risk weighting itself therefore needs to be comprehensively reviewed. This seems to be the challenge of the new macroregulation: to accurately evaluate systemic risk while at the same time giving the authorities the tools for prompt preventive intervention.

What should the perimeter of regulation be?

Recent events have clearly shown that the perimeter of regulation also needs to be reviewed, because of the negative external effects that some institutions have on others in moments of crisis. In fact, in the most acute phase of deleveraging, that is, when the banks have sought to get rid of their most risky assets to respect their equity coefficients, they have experienced the negative effect of the fact that other institutions, such as hedge funds, were also engaged in trying to sell the same financial assets, fearing that prices would collapse, and to deal with their liabilities. In other words, some financial institutions are outside the perimeter of regulation, yet play an important role in amplifying any crisis. So it could be opportune to bring such institutions inside the regulation perimeter.

Another serious aspect is the total lack of transparency about the actual systemic risk of the financial system. The use of structured investment vehicles, or other vehicles whose accounts are not consolidated with those of the financial institution to which they belong, and interactions with hedge funds, which are not subject to financial regulation, have on the one hand made it impossible for the supervisory authorities to understand the true magnitude of the risk taken by the banks - and on the other, have made their capitalisation even more evidently inadequate. So it will be vital to impose a new reporting system on those financial institutions that agree to evaluate systemic risk.

International banks and national regulation

The business of banks is increasingly international, especially in Europe. So the balance sheets of the banks are determined by all their business in different countries put together. But supervision remains primarily national. The example of Iceland, with its banks which had extended their depositor base to the United Kingdom and the Netherlands, shows how this can create tensions. An authority at the European level could be a way of attenuating these tensions.

It has been repeatedly emphasised that the banks are international while they are alive, but are again national when they die. In more concrete terms, saving banks in difficulty is always the responsibility of the countries in which they have their registered offices. But the bail-out effects (or the non-occurrence of bail-out, as in the case of Lehman Brothers) are often felt at the global level. So a procedure needs to be identified that could, at the international level, share both the authority responsible for deciding on bank bail-out operations and the cost of such operations.

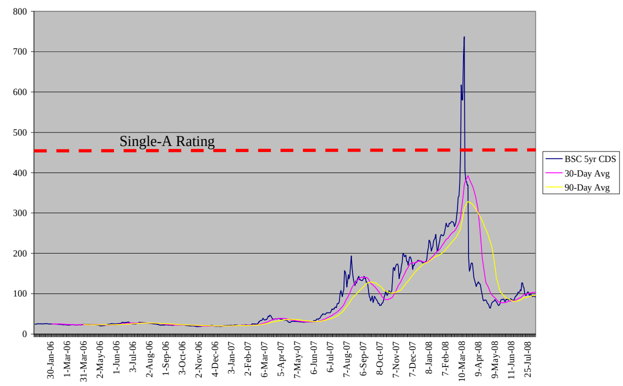
The false myth of self-regulation: the fall of credit ratings

In the past there has been great faith in the capacity of the financial market to regulate itself, through reputation-based mechanisms, or specialised intermediaries who acted as gatekeepers. It was believed that if people could not be trusted, the most illustrious companies or institutions with a long tradition behind them could be. The crisis has undermined, perhaps definitively, the faith that the market placed in these institutions and the so-called “private forms of regulation”, which certainly were very popular in recent years. In particular, fingers are being pointed at the rating agencies.

Many commentators emphasise that it was precisely an excessive reliance on the ratings agencies which was one of the causes that triggered the crisis. If the market had not relied so heavily on ratings, then in all likelihood complex financial instruments such as SIVs, the structured investment vehicles mentioned above, or CDOs – collateralised debt obligations, would not have been created and placed on the market. Over time, the ratings agencies stopped performing their “institutional” role as certification intermediaries: gradually, as the operators sought to securitise increasing volumes of subprime mortgages, the agents, in exchange for lavish commissions from the issuers, granted licences to place tranches of these instruments on the market with ratings that were absolutely unjustified in relation to their underlying risks. Some of the data are shocking. The credit default swaps – the market prices of which provide a measure of the risk of bankruptcy – of a bank such as Bear Stearns show the progressive increase in the risk of insolvency in an unequivocal way, reaching a peak of over 700 points in March 2008 (see Figure 1) . Yet during the whole of this period Bear Stearns’ A rating was unaffected. One aspect that is in some respects a paradox is that the ratings are a fundamental part of regulation, since they contribute to the weighting of the riskiness of assets according to the Basel II arrangements.

So the ratings agencies have serious responsibilities in crises, and policy-makers must take this into account in the design of the new regulation. But it will not be easy to replace them, both because they have been one of the foundations of the financial markets for such a long time, and because today governments desperately need their help to successfully place their own new debt on the market.

Figure 1. Bear Stearns 5-Year CDS Market Spreads (bp)



Source: Markit

Conclusions

Poor regulation contributed to make the financial crisis more acute and more global. While reforming regulation will certainly not be the key to overcoming the crisis, it will perhaps help us to avoid others in the future. It is true that new rules often serve only to combat the crises of the past. To avoid this, it is important that the new rules are based on a solid analysis of the current situation, sorting the inessential from what is, in contrast, substantial. The ideas that emerged in the workshop held at the Fondazione Eni Enrico Mattei can help us to understand what direction we should be moving in.

This Policy Brief builds upon the proceedings tof the FEEM-Bocconi Workhop "*Back from the Brink: Rethinking Financial Regulation*", 27 March 2009, Milan, Italy