CENTRE *for* ECONOMIC PERFORMANCE

ELECTION ANALYSIS

Financial Regulation:
Can We Avoid Another Great Recession?

- The Great Recession of 2008-2010 had its roots in the crisis of financial markets, which spread to the real economy.

- The structural problem with the financial sector is that there is strong ‘contagion’ between institutions within the financial sector and also between the financial sector and other parts of the economy. A large bank can pull down the financial sector, which can, in turn, pull down large parts of the rest of the economy in a ‘domino effect’.

- Because of these contagion effects, governments will inevitably bail out banks; and because banks know this, they take excessive risks. This structural ‘moral hazard’ problem has not been dealt with by the existing regulatory regime.

- To deal with the problem, we need to (a) make bankruptcy more credible; (b) shrink the size of banks so that there are fewer organisations that are ‘too big to fail’; and (c) improve existing regulations in a variety of ways.

- Most current proposals do not deal with this fundamental problem. Improving corporate governance, reforming bankers’ pay and crude taxes on all banks and/or financial transactions are mainly distractions.

- Without reform, the risks of a repeat financial crisis have increased. There is *less* uncertainty that governments will bail out banks, and key sectors like investment banking are more concentrated.

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Introduction

The fall in the UK's GDP since the start of the recession in 2008 has been greater than any other since the Great Depression. The global Great Recession originated in the financial services sector, especially after the collapse of Lehman in September 2008.

Although there were many catalysts – such as the global macroeconomic imbalance between high spending America and high saving Asia, and inflated property markets – these problems became toxic because of the financial sector. There was an extraordinary mispricing of risk, which led, in crisis, to massive state support and the subsequent deterioration of the public finances.

This Election Analysis examines what went wrong with the regulatory system for finance and how can it be fixed.

The fundamental problem

There are two key economic considerations:

First, liquidity problems in some financial institutions can spread very quickly through other institutions. This is what is called the within-industry 'contagion' effect: when the system is interconnected, 'systemic risk' is high, and the whole system can collapse. What makes this is a particular problem is that all businesses rely on finance to function – when the sector contracts, it pulls down the real economy with it. Crises in other industries are painful – car manufacturing, for example – but not fatal to the health of the economic system.

Second, there are excessive incentives for risk-taking in financial institutions. This is the result of the government offering (explicit or implicit) protection for financial institutions against bankruptcy. This in turn protects lenders – and not just depositors, but largely all lenders – from bad decisions. This is the 'moral hazard' problem.

The moral hazard issue is largely a result of an effort to avoid the contagion effects: avoiding panics requires insuring depositors and other players, and this requires regulating the industry to avoid excessive risk. In other words, if we are going to provide rescues and bailouts, we have to limit risk-taking. Unfortunately, these regulatory safeguards did not work.

The essence of capitalism is that people accept responsibility for the risks they take – they enjoy the upside wins, but also suffer the pain if the bet goes the wrong way. Without this, we get the moral hazard problem as the downside protection encourages firms to take excessive risk. In other words, 'heads, I win; tails, society loses'.

Narrow banking and the Volcker Rule

A large part of the initial reform push has focused on the 'Volcker rule'. This is the suggestion made by President Obama is that 'Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, proprietary trading operations or for their own

profit, unrelated to serving their customers.'[1] This has been enthusiastically embraced by the UK opposition parties.

Although the proposal tackles one aspect of the problem – a bank gets cheap money thanks to deposit insurance, and then uses it to gamble on the casino of 'proprietary trading' – it has two shortcomings.

The first shortcoming is that 'prop trading' is not the only way financial institutions take excessive risks; in the recent past, the largest problems have been in their 'plain vanilla' loan portfolios – banks can take too much risk in simple mortgage-backed real estate loans. In fact, several of the key institutions that collapsed – AIG, Lehman, Northern Rock and Bear Stearns – would have been left completely unaffected by the Volcker rule.

A second shortcoming of the proposal is that its implementation would be extremely complicated. Separating hedging activities from pure speculation has always been extraordinarily difficult.

Making bankruptcy credible

The solution must lie in reinstituting some fundamental discipline: if a company has too much debt and becomes insolvent, taxpayers have no responsibility. The company suspends payments, it closes and its shareholders and creditors lose their money.

How can this threat be reinstituted and become credible for financial institutions after Lehman? To make bankruptcy attain the role of disciplining managerial behaviour, two changes need to take place:

(1) Financial institutions must be of a size, complexity and interconnectivity that allows the regulator to promise credibly that they will be allowed to fail. In other words, there must be no banks 'too big to fail'. As US Congressman Sanders and Bank of England Governor Mervyn King put it: 'if you are too big to fail, you are too big to exist'. This can be done through a tax that grows with the size of assets or a literal limit to the size of the balance sheet.

(2) Living wills[2] must be credible and real, so that any financial institution can disappear in a weekend without creating chaos – unlike in the post-Lehman disaster.

Of course, size is not the only characteristic that defines a systemic institution, but it must be one of the relevant criteria. First, size should be size in the country. For example, while Deutsche Bank (DB) has a balance sheet in the billions of dollars, similar to the Royal Bank of Scotland (RBS), home assets of DB are only 16% of German GDP while for RBS, they are 71% of UK GDP.[3]

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[1] http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.
[2] A living will is a clear statement over what would happen to the assets of a bank were it to fail. Thus it forces transparency on the counterparty risks of different positions held by the bank. These need not necessarily be made public, but they must be available in a timely fashion to the regulator.
[3] JP Morgan Europe Equity Research, 'Global Banks: Too Big to Fail?', 27 February 2010, p9.

Second, the diversity and complexity of activities within a bank and the interrelationships between them should also be critical criteria in establishing the systemic risk of an institution. If investors and counterparties cannot have a view of what the institution is doing, any problem in any activity may raise doubts about the viability of the whole institution. But complexity also makes it hard for the supervisor to predict the consequences of failure, and thus makes it more likely that intervention will be needed.

Third, the centrality of the institution matters. An institution that is very closely connected to others in the system will be more likely to bring others down in case of bankruptcy.

Finally, there are institutions that by their peculiar sphere of action and the novelty of their activities, either by the use of financial innovations or simply expanding their business activities, may pose more systemic risk.

Once identified, systemic institutions require unique regulatory solutions. Ideally, no institution should be systemic. Credible bankruptcy requires that no institution is too big, too complex or too central; regulators should ensure that this is the case.

Taxing bank size

An alternative approach to dealing with size is by taxing it – by imposing a cost on the institutions that grow too large so that institutions may be forced to internalise the externality they impose on the system due to the lack of bankruptcy threat. This would allow extremely efficient banks to grow large as they would be willing to bear the costs of a highly progressive tax.

A particularly appealing form (and related to the Obama tax proposals) would be to tax institutions as a function of the amount of short-term financing they are using. This is a variant of the Obama tax on bank non-deposit liabilities, which was proposed in the United States only provisionally (to recoup TARP) but which could have a wider economic aim: it would simultaneously discourage excessive size and wholesale financing, two of the key causes of the crisis.

New regulations, better regulators

Making bankruptcy more credible is the essential step that would lead to a more efficient and less risky and fragile financial system. But better regulation and regulators are also necessary. These should involve three main steps:

1. ***Centralised derivatives markets***: A complement to making bankruptcy more credible would be greater transparency. A centralised payment system allows managers access to information on the risk exposure of individual institutions.

It is hard to understand why the standard contracts currently traded on over-the-counter (OTC) markets are not being traded in centralised markets. Centralised markets would have reduced many of the uncertainties that took place after the Lehman collapse and would allow investors and supervisors to understand better the evolution of derivative markets.

2. ***Higher liquidity and solvency requirements***: A key axis of the current reform proposals is increasing solvency requirements. Concerning capital requirements, the main proposal here is increasing solvency requirements through contingent capital – debt that would be transformed into equity automatically when certain triggers are reached, which could be market triggers (such as credit default swap prices[4] reaching a certain level) or regulatory triggers (core or tier 1 capital reaching a certain minimum).

These proposals have merit, but as the crises tend to be liquidity driven, and they do not really generate 'true' new capital, they are unlikely to solve a crisis.

As for liquidity, a key problem was excessive short-term financing of long-term liabilities. The tax mentioned above on wholesale or short-term financing would also help to deal with this problem.

3. ***Systemic supervisors***: A big push here involves the creation of a new set of worldwide systemic supervisors with the function of looking at the 'forest' of systemic risk, rather than the 'trees' of how each individual bank is performing.[5] It is essential that supervisors have real teeth, including ability to impose penalties on non-complying financial institutions.

One question is the extent to which the systemic supervisor role must coincide with the central banking function and be undertaken by a central bank. Synergies between both functions are important as Northern Rock showed.[6]

Exercising the 'lender of last resort' functions (which only central banks can do) requires knowing the state of the banks that may have to be rescued, while the information about the state of lending and asset quantities and prices held by the banks is an invaluable tool of monetary policy.[7] Whether this requires merging the Financial Services Authority (FSA) back into the Bank of England (as the Conservatives propose) or improving co-operation is less clear.

Some non-solutions to the regulation problem: corporate governance and bankers' bonuses

Many of the proposed 'solutions' to the problem of financial regulation by the main parties are wide of the mark and risk distracting us from the major reform tasks.

Often, policy-makers talk of improved corporate governance to stop senior managers and CEOs from 'ripping off' shareholders. But for firms relying on the protection of taxpayers, the conflict of interest is *not* fundamentally between bank managers and shareholders because the manager wants to earn too much or wants to build an empire or to own a private jet.

Instead, the conflict is between, on one side, managers and shareholders and, on the other side, taxpayers. Both managers and shareholders (and even holders of corporate debt) take advantage of the protection of the state to take excessive risks, since it is the taxpayer who

[4] A method based on credit default swap prices has been proposed by Hart and Zingales (2009).
[5] See Goodhart (2009).
[6] See Shin (2009).
[7] For a clear statement, see the very well argued testimony of Anil Kashyap (2010) to the US Congress; see also *The Squam Lake Report* (2010) and Garicano and Lastra (2010).

ends up paying. Therefore proposals to improve transparency and corporate governance are completely useless for solving these problems.

Exactly the same argument goes for proposals to align pay more effectively with shareholder interests. The structure of annual bonuses for traders and managers in the financial sector does encourage an emphasis on short-term excessive risk-taking. But this is likely to be a consequence of structural moral hazard not the cause. It is dealing with the symptom and not the disease (see Bell and Van Reenen, 2010).

Third, generalised taxes on banks (as proposed by the Conservatives) or global financial transactions (proposed by Labour) are not well-targeted at the problem of systemic risk. Focusing on a more targeted tax regime to reduce the 'too big to fail' problem would be a better way to go.

Finally, further competition authority investigations into banking as proposed by the opposition parties will tell us what we already know. These have become very concentrated industries that threaten welfare – not for the usual reasons (high prices and low innovation) but rather for the risks of a further financial meltdown. The cause comes from the problem of structural moral hazard and the solutions cannot be delegated to the competition authorities.

Conclusions

The financial meltdown led to the worst post-war recession experienced by the UK and other advanced economies. The fundamental regulatory problem in the financial system is that the government will bail out the banks because of the risk of contagion from organisations that are 'too big to fail' to the rest of the economy. This structural moral hazard problem causes large financial firms to take excessive risks.

To deal with this we have to operate on the fundamental problem, which means increasing the real threat of bankruptcy and shrinking down the organisations that pose such systemic risks. We should not get distracted by reforms such as changes in corporate governance, bankers' pay, bank levies, Tobin taxes or competition inquiries.

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