Financial regulation after the crisis: *prospects for reform*

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G20 objectives (November 2008)

- *Our financial markets are global in scope...intensified international cooperation among regulators and strengthening of international standards...[are] necessary to protect against adverse cross-border, regional and global developments...*
- *Regulators must...support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage...*
- *Regulators ...should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends...*
- *...review resolution regimes and bankruptcy laws...to ensure that they permit an orderly wind-down of large complex cross-border financial institutions...*
- *Regulators should...ensure that credit rating agencies ... avoid conflicts of interest [and] provide greater disclosure*
- *Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS)...should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms...*
- *Supervisors ...should develop robust and internationally consistent approaches for liquidity supervision of...cross-border banks...*
- *Financial institutions should...avoid compensation schemes which reward excessive short-term returns or risk taking...*

Results and prospects

- Tax havens and money laundering
- Hedge funds and private equity
- Dodd-Frank and European counterparts
- The banks
  - incentives
  - size and too big to fail (TBTF)
  - resolution regimes and cross-border cooperation
- Macroprudential regulation
- Derivatives markets
- Ratings agencies
- G20 and cross-border conflict : ‘wasting the crisis’

Wasting the crisis

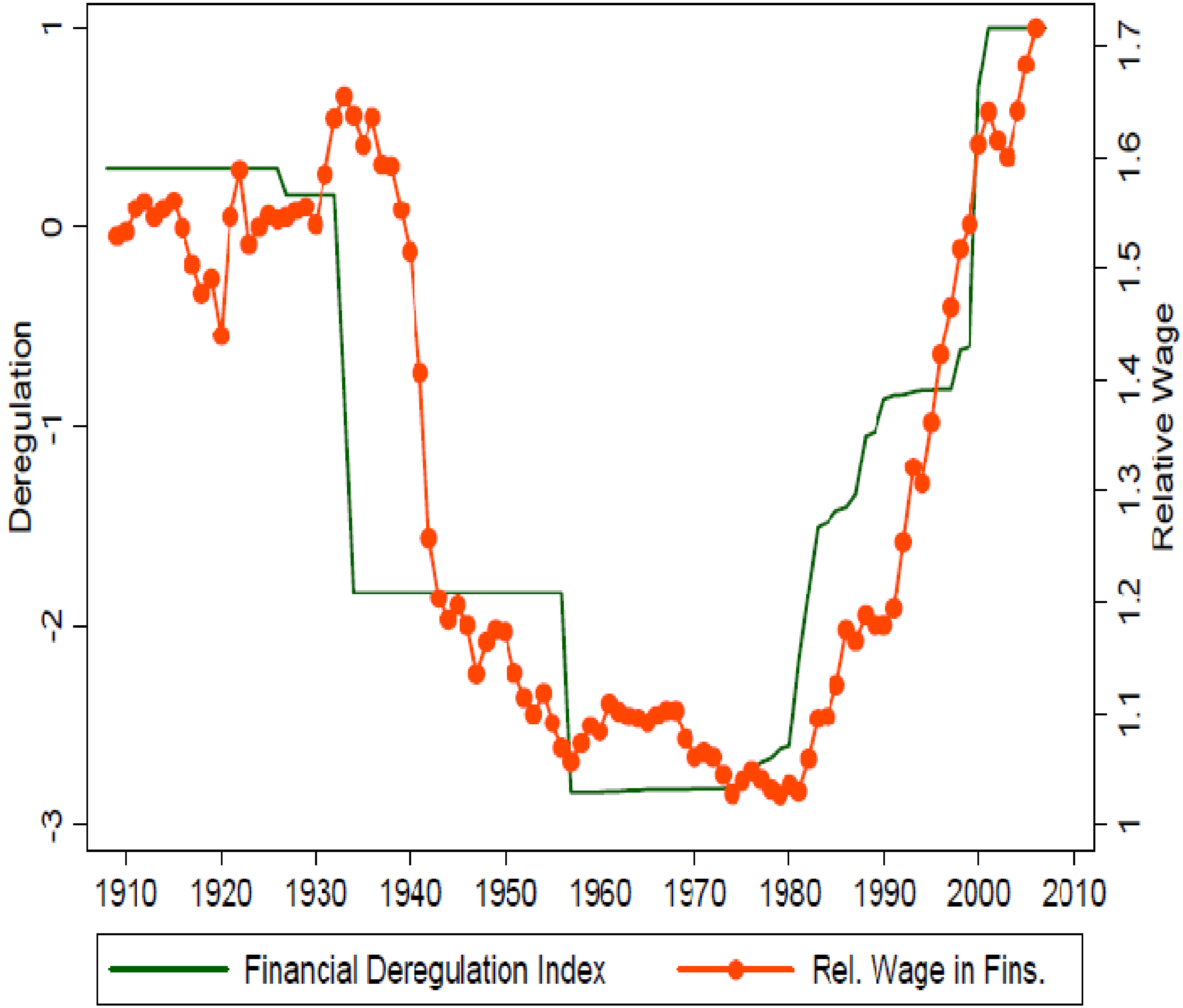
- Do the easy things that are irrelevant: tax havens and money laundering (why weren't they shut down before?)
- Focus on the crowd-pleasers: regulating hedge funds and private equity, bonuses - also mainly irrelevant
- Do little serious about the important issues: ***the banks and shadow banking system, macroprudential regulation, derivatives markets, rating agencies, cross-border conflicts***

Bonuses

- Will new compensation rules curb dangerous risk-taking and instil long-term incentives? Employees of Lehman and Bear Stearns had most of their personal wealth in their firms' shares...
- The quick return of massive bonuses is indeed offensive - but so was the huge widening of income differentials in favour of the financial sector over the last two decades - and that is probably related to *financial deregulation*
- Caps will be evaded in the competition for 'stars'
- Never mind - politicians can placate public wrath, let resurgent banks do what they like (nothing serious in Dodd-Frank)

Figure 6: Relative Financial Wage and Financial Deregulation

Source: Philippon and Reshef, 2009, ‘Wages and Human Capital in the US Financial Industry’, CEPR Discussion Paper no. 7282,



Notes: Wages are computed from the Industry Accounts of the U.S., from Kuznets (1941), and from Martin (1939). The relative wage is the ratio of Fins to Non Farm Private wages. See the text for the definition of the deregulation index.

Hedge funds and private equity

- Is there any ***evidence*** that HF or PE had any significant role among causes of the crisis?
- The European Union’s Alternative Investment Fund Managers directive is crude, protectionist, a distraction

Banks are back to ‘business as usual’

- Banking sector already highly concentrated pre-crisis, now even more so - they have *even more monopolistic and political power*, and ‘consolidation’ hasn’t finished
- Banks not just TBTF (or TBTR), they are simply ***too big*** - to regulate, even to manage - and huge barriers to entry
- New Glass-Steagall? Certainly not! ‘Volcker rule’ not GS, hard to implement
- Could ***break them up*** - but only European Commission might do a little of that, US DoJ and UK Competition Commission not interested, nor finance ministries
- No legislative authority in D-F, UK Banking Commission unlikely to recommend breakup, government not keen

Can we do anything about the banks?

- *Tax size*: capital ratios that rise with size, or a tax based on size of assets - fine, but lobbyists will kill it (tax on 'systemic importance' impossible to implement)
- 'Tobin tax' wouldn't affect bank size (and won't happen)
- Even US administration's populist 'consumer protection agency' likely to be weak
- A 'capital conservation' framework - Sec-Gen of FSB:

'We're talking about things like powers to restrict dividends, restrict share buybacks, possibly restrict compensation and bonus payments if those payments threaten...capital adequacy'

- Cheap talk?

What we are likely to see

- Some political support for *'living wills':* systemically important banks would set out *ex ante* detailed proposals for resolution that regulators would agree with bank and each other
- But doing this properly would require *ex ante* cross-border burden sharing
- Contingent capital also getting some support
- But so far, Basle III is very weak (capital ratios not high, long transition, no leverage cap) - and banks still complain!
- Dodd-Frank Financial Stability Oversight Council, EU European Systemic Risk Board - neither will make much difference
- Very little on 'shadow banking system'

Macroprudential regulation

- *Countercyclical capital ratios*, liquidity ratios, leverage ratios, loan-to-value ratios (for mortgages)
- We'll probably get countercyclical capital ratios, but *not high enough*, leverage ratios, but not low enough
- The business cycle is national - so host regulator has to rule, hence pressure on cross-border LCFIs to go from branches to subsidiaries (branches of global banks would be treated differently in different countries)
- Would subsidiarisation (or forcing banks to be much smaller) impair 'global intermediation capacity'?

Markets: derivatives are key

- Volcker: ‘creation of derivatives has far exceeded any pressing need for hedging’
- But financial markets and finance professors argue for ‘market completeness’ - any innovation is good!
- Commodities and Futures Modernization Act 2000 blocked any regulation of derivatives, a major mistake - there is some reversal in Dodd-Frank, including some separation of derivatives trading from banking

Policy failure

- Move to central counterparties for OTC derivatives (slowly and not fully), maybe position limits
- But ***won't require exchange trading*** of these instruments - the opacity and specificity of OTC is just too profitable for the banks to give up (Bolton et al.) - lobbying intense
- And ***won't ban 'naked' CDS*** - although crisis has shown that these are dangerous tools for speculation and market manipulation, rather than benign hedges

Rating agencies

- Will separate rating from ‘advisory’ services
- ‘Monitoring’ of agencies and their models - useless
- Unlikely to make much progress in breaking up the oligopoly...
- ...unless authorities ***remove the ‘regulatory license’*** - regulators have ‘outsourced’ their responsibilities for evaluating riskiness of institutional portfolios
- SEC might go a bit in this direction, no sign that UK or Continental Europeans will do

Cross-border issues

- Competition in labour market makes it hard to regulate compensation
- Competition among financial centres (NY and London, also Paris and Frankfurt) - regulatory arbitrage, which banks openly exploit
- Competition among LCFIs, national authorities hesitate to disadvantage their own - ‘supervisory colleges’ are feeble
- Cross-border cooperation in ex post winding up? Despite MOUs, in crisis there is no time, too complex
- So do need ex ante ***‘living wills’*** - which would also force simplification of bank structures

Whatever the politicians and regulators do, it will be too little, too late - and the next crisis will be different