SEVEN PILLARS OF WISDOM

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Prologue

- *But for fit monument I shattered it, unfinished: and now*

  The little things creep out to patch themselves hovels
  In the marred shadow
  T.E. Lawrence

The Crisis and Regulation

- After a vigorous expansion, the financial system came close to collapse in 2007.
- Financial fragility derived from credit and liquidity risks being underestimated through a combination of complacency, political opportunism and greed.
- Regulation contributed to the crisis by herding firms into making similar choices. It is not surprising that its role is under scrutiny.

What do we expect from regulation?

- To design ‘good’ regulation it is necessary to specify what we expect to achieve.
- A regulatory system should reduce risk from failing financial institutions to depositors and taxpayers.
- It should also not aggravate economic crises by forcing banks to make similar choices or inducing procyclicality.
- Excessive prudence may also carry a cost, by stunting economic growth.

The Basel Agreements

- The Basel Agreements were meant to regulate banks, creating a level playing field in the new global markets.
- They set minimum standards, that often do not reflect well underlying risks
- Competitive pressures make banks cluster near those standards, enhancing systemic risk.

The Three Pillars

- Regulation in Basel Agreements is based on three pillars:
- Capital requirement
- Supervisory review
- Market discipline

The recent crisis illustrates shortcomings in all of them. We'll see how.

Capital Requirements

- A portion of risk-weighted assets should be financed by banks’ own capital.
- Risk weights are inadequate. Risk changes.
- Capital is meaningless if not fully marked to market.
- Old-fashioned reserves with central banks were more meaningful.

Supervisory Review

- Bank supervisors should endorse risk management process and verify that results are in line with expectations.
- Capital requirements are doubled or trebled if results are much worse than predicted. That is very questionable.
- Good corporate governance is the first line of defense.

Market Discipline

- Information must flow to markets for MD to work. Incomplete information about SIV and structured products before the crisis has been followed by the suspension of disclosure rules during crisis, leading to market seizures, solved by massive public intervention.
- Resolution of failing institutions through aquisitions leads to even larger institutions, that markets deem 'too big to fail', destroying market discipline.

What is wrong with capital req.

- Impossible to enforce in a crisis.
- Economic capital hard to measure, regulatory capital not always meaningful for risk management .
- Minimum requirements do not allow for graduate regulatory response.
- Linked to VAR, rather than expected shortfall.
- Capital is not expensive (M&M), unless it dilutes value of public guarantee.

What is wrong with supervision

- The supervisory review process is subject to substantial conflict of interests.
- Supervisors are always behind the curve of financial innovation. They are captive of industry know-how.
- Forebearance and the pretense of stability are the easy way out when crisis strikes.
- Supervision by boards and regulators is constantly eroded in good times. Supervisory arbitrage reinforces that.

What is wrong with market discipline

- ‘Too big to fail’ destroys market discipline.
- Managers must maximize risk to increase the value of implicit private guarantee, that they can monetize and share with stockholders.
- Maximizing risk subject to formal constraints reinforces herding, leading to systemic risk.
- Opacity is encouraged through oligopolies:

  Rating agencies, OTC markets, auditing.

To junk Basel Agr. or to shore it up?

- It is necessary to decide whether we try to repair current regulation or throw it away and take a different approach (Glass-Steagall?)
- If we attempt to repair it we may introduce some new pillars to shore it up. *A good building needs seven pillars!*
- The resulting architecture may be too complicated. However it evidences some flaws of current design that must be addressed.

Risk Reserves

- Reserves on deposit with central banks provide liquidity and risk coverage. To fulfill the latter function should be related to risk.
- Economic capital is at risk and hard to measure. Regulatory capital is easier to measure, but meaningless. Reserves are meaningful, easy to measure,can be riskless.
- Reserves cannot resolve risk ambiguity. They are useful to set limits to the liquidity mismatch banks necessarily carry.

Risk Fee

- The residual risk on the public should be covered by a risk fee, updated frequently.
- It is not easy to price, though we may improve on its current pricing (zero).
- Precommitment may help, if supplemented by ex-post penalty. Banks then bear model risk.
- Excessive fees increase regulatory burden and discourage growth. Overall burden should not be much increased.

Deferred Compensation

- Deferring compensation discourages managers and traders from short-termism.
- It reduces conflicts between managers and shareholders. It does not resolve the conflict with the ‘lender of last resort’. The managers of several of the big banks that failed had very large stakes.
- G 20 measures in this direction are marginally useful.

Separation of Finance and Commerce

- A postulate of our analysis is that banks are value maximizers. That is false if stockholders have other priorities (private benefits).
- To limit private benefits, boards should not be client-dominated. Loans to stockholders should be forbidden, as in UK.
- Icelandic banks collapsed when shareholders' loans were no longer covered by share value.

Why all seven pillars are necessary

- All the seven pillars seem to be necessary to plug current regulatory holes and achieve our target of protecting public interest.
- The multiplicity of proposed measures should allow for the design of regulatory systems that discourage herding, reducing systemic risk. We should move from a system based on minimum requirements to a system offering trade-offs. That is easier to control.

What has been done to date

- More attention to liquidity and to deferred compensation since the crisis, in line with pillars IV and VI.
- Pillars V and VII largely ignored. Pillar V actually roughly implemented for ring-fenced assets in UK, not for entire banks, that show increased risk appetite. The watering down of Pillar I covers that.
- Pillar VII enforced in some jurisdiction, denied elsewhere.

Return to Glass-Steagall?

- The separation of commercial from investment banking has been advocated by many economists. It is a solution that provided 60 years of stability.
- At this point it is difficult:activities are intertwined (swaps, MBS, FX). Moreover large investment banks survive only because they access central bank liquidity.
- In US many non-bank institutions escape G-S.

Two more options

- Precommitments may play a role for traded risks, where prices are frequently revised. They are not credible for claims held over long time with no marking to market.
- Contract rescission by bond insurers is becoming a trend in North America, introducing a large legal risk. We have no answer to that.

‘This time is different’

- Bubbles defy usual risk management tools.
- Investors, thinking that a class of assets has been greatly undervalued, buy no matter what risk they perceive.
- If the revaluation turns out not to be permanent, we call it a bubble.
- It is possible to detect the potential for a bubble. Ex-ante it is hard to distinguish it from a permanent re-evaluation.

Macro supervision

- Macro tools have been proposed for market surveillance. Often they lead to reduced-form models with unstable coefficients.
- Big macro risks usually escape these models (a trivial case is the break of a currency peg). If they are known and relevant, generally financial markets anticipate it. If they are unknown, econometric analysis seldom catches them.

Toward next crisis

- The waning of emergency weakens appetite for reform.
- Token measures leave a weakened financial system ready for next crisis.
- The precariousness of liquidity supplied by Central Banks discourages weak institutions from lending activity. Short-term trading in financial markets provides chance for quick recovery. Lack of volume points to risk of sudden reversal.

Too much liquidity?

- Many observers are relieved by the return of the TED spread to pre-crisis level. The TED spread has been very low (0.2-0.3%)for most of the noughties. Before it was moving between 0.5 and 1.5%.
- Perhaps that was a more prudent outlook for credit risk. A low premium may be necessary for recovery, but it has encouraged past reckless behavior.

Volker’s proposals

- Elimination of proprietary trading, hedge funds and private equity funds from bank activities.
- The difference between proprietary trading and market making is not clear cut. Reducing diversification may increase bank risk.
- Creditors are not protected, except depositors. Bank runs and asset substitution are open issues.
- These measures reduce some conflicts of interest. They are unlikely to reduce systemic risk.

Asset fees

- Banks are willing to consider fees based on assets. That is a poor proxy for risk fees.
- Asset fees may be structured to discourage very large institutions, reigning in systemic risk. But within each class each bank has still the incentive to take more risk than its competitors.

Conclusions

- The debate on financial reform is not reaching a consensus. That may undermine the principle of global regulation.
- Lacking a level playing field, eventually it may become necessary to attribute clear powers and responsibilities to individual states and firewall their borders.
- A possibility would be to have separate banks with distinct capital in each country, owned by global bank holding companies.
- That will improve stability at great capital cost, reducing economic growth. In any case, any good architecture implies a trade-off between growth and stability. We have paid too much attention to growth.