Redesigning Financial Systems

It is some 15 months since the sub-prime crisis raised its ugly head. Rather than gradually subsiding, the after-shocks have amplified. Beyond the immediate financial sector disruption, current events presage a wide-spread rethinking of the appropriate supervisory and regulatory arrangements for modern financial systems.

In a couple of very bad weeks for the US (and international) financial system, Fannie and Freddie have been "un-privatized", Lehmann Brothers has entered bankruptcy, and Merrill Lynch is being acquired by Bank of America.

In addition, there are ongoing concerns about the financial strength of monoline insurers and heightened concerns about insurance giant American International Group (AIG) due to losses from their underwriting and investing activities in the markets for complex financial instruments which have caused the spread of the crisis.

The number of commercial banks on the "problem list" of the FDIC had increased to 117 in June, and concerns hang over the soundness of some large banks with significant mortgage related exposures.

Three specific longer term issues stand out for the future regulation and shape of the financial sector: financial system liquidity management; resolving troubled financial institutions; and consequences of the growth of financial behemoths spanning commercial and investment banking and most other parts of the financial sector. Designing, via appropriate legislation and regulation, an efficient, dynamic, financial system while reducing the likelihood and costs of crises, is a challenge still awaiting a solution.

This challenge is particularly difficult because of the complexity of the financial system. Financial interrelationships between major participants dwarf the scale of their business with the real sector (business and households) and involve complex financial products. Modern liquidity management relies heavily on being able to access funds from other institutions (as short term borrowings or through repos), or being able to sell tradable securities into liquid markets. Risk management is similar. Transactions between financial institutions generate direct linkages involving counterparty credit risk and possible spillover effects from the failure of any one institution.

And confidence is the key – and fragile because opaqueness makes it extremely hard for outsiders (and apparently insiders as well) to determine the financial strength of complex institutions. Concerns (real or imaginary) about an institution's solvency reduce its ability to access liquidity, and can force it into value destroying transactions which ultimately force insolvency.

Hence Central Banks have dramatically expanded their liquidity support arrangements, with the US Fed using securities lending arrangements (loans of Government Bonds against an increasingly broad range of (hopefully higher valued) collateral) and increasing the range of potential participants to include investment banks. Although such transactions are meant to be done on "commercial" terms, it is difficult to avoid the conclusion that access to liquidity support arrangements is something of a competitive free kick for eligible institutions – perhaps warranting some regulatory quid pro quo.

Arrangements for dealing with failing institutions are also being made on the run. Government sponsored, tax-payer funded, solutions for Bear-Stearns, and Fannie and Freddie, have not been followed up by a similar approach to Lehmanns. While its Chapter 11 bankruptcy provides scope for reorganization rather than a fire sale of assets, the risks of further financial disruption from its failure are significant as its contracts with counterparties (involving debt of around $800 bill and somewhat smaller assets) are unwound.

Nevertheless, rejecting the "too-big, too-systemically-important-to fail" perception, the US Government has avoided extending further taxpayer bail-outs to the investment bank. Whether that constitutes a "line in the sand" preventing similar large complex institutions benefitting from that perception in the future is, however, problematic.

What can be done to refashion financial systems to provide a "safe haven" for unsophisticated depositors and investors, while allowing a dynamic less regulated sector whose players are exposed to risk of failure without the implicit subsidy of possible government bail-out?

The "narrow banking" model, in which depositor protection applies to supervised institutions restricted to a limited range of low risk activities has some appeal.

That may protect unsophisticated depositors, but it won't prevent financial crises. Nor will it prevent unsophisticated investors being exposed to the vagaries of the securities markets and to complex financial products via the decisions of professional managers of superannuation funds. That growing international pool of retirement savings will underpin the reemergence of investment banking and accompanying financial innovation, making the design of suitable regulatory arrangements for investment banking, securities markets and pension funds the most pressing issue for government policy makers.

Kevin Davis
Commonwealth Bank Chair of Finance, University of Melbourne
Director, Melbourne Centre for Financial Studies