Financial Regulation after the GFC

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3 Prerequisites

- Successful post-GFC financial regulation requires
  - a considered assessment of regulatory and market failings responsible for the crisis
  - Identifying those factors which created difficulties in dealing with the crisis
  - unwinding and/or refining the myriad of regulatory interventions made in the wake of the crisis

Inquiries, Reviews, Committees

- de Larosière Report (European Commission, 2009)
- Turner Report (FSA, 2009)
- Volcker Report (G30, 2009)
- G20 - February 2009 declaration of Prime Ministers and Working Group Reports
- Financial Stability Forum report (FSF, 2009)
- IMF report (IMF, 2009)
- Walker Review (Bank Governance, UK, 2009)
- Basel / IOSCO (eg TFUMP) reviews/recommendations
- Private sector reports
  - International Institute of Finance (IIF, 2008)
  - Geneva Report (2009) a group of prominent economists.
- G20 Finance Ministers Progress Report (5 Sept 09)

Australian Parliamentary Inquiries

- Senate Economics Committee
  - National Consumer Credit Protection Bill 2009
    - Interim Report July 09
  - Aspects of Bank Mergers (Report due 17 Sep 09)
  - Bank Funding Guarantees (Report due 15 Sep 09)
- Joint Committee: Corporations and Financial Services
  - Financial products and services (Report due 23 Nov 09)
- House Economics
  - Competition in Banking and Non-Banking sectors (21 Nov 08)

Other Australian Reviews/Policies

- Review of Superannuation System (Cooper)
- CAMAC – aspects of market integrity (June 09)
- APRA
  - Remuneration in prudentially regulated institutions
  - Implementation of Basel "enhancements"
    - Market risk, securitization, risk management practices, disclosures, liquidity risk
    - Cyclical capital buffers, "quality" of capital, leverage ratio, forward looking provisioning
- ASIC – recent consultation papers include
  - Credit licencees, margin lending, securities lending, short-selling

Theory and Practice

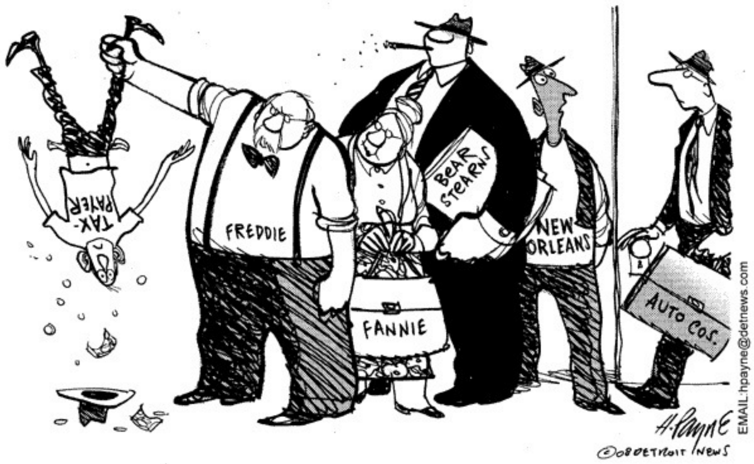
"Will academic theory change in the light of the GFC?

For macroeconomics…the gulf between practical policy and the cutting edge theory most likely will remain…

At the micro level, the efficient markets hypothesis has taken a direct hit…its credentials as an intellectual rationale for self interested minimal regulation are gone"

Stephen Grenville "Postcrisis economics" Australian Financial Review 11 May 2009 P. 20

Policy Responses to the Crisis



"Take a number."

GFC Causal Factors

- Failures in Macro-economic policies
  - Liquidity creation, leverage, asset price inflation
- Failures of Risk management/governance
  - Financial institutions, investors, ratings agencies
- Complex/unsuitable financial products
- Breakdowns in supervision and regulation

Blame – Maybe the MBA's

- "The Masters of Business Administration, that swollen class of jargon-spewing, value-destroying financiers and consultants have done more than any other group of people to create the economic misery we find ourselves in." The Sunday Times ("Harvard's masters of the apocalypse" March 1,2009)
  - Masters of the Business Apocalypse
  - Mediocre But Arrogant
  - Mighty Big Attitude
  - Me Before Anyone
  - Management By Accident

A Belts and Braces Response

- Unfreeze/restore liquidity
- Shore up public confidence
- Failure management
- Temporary regulations
- Macro-economic stimuli
- Regulatory forbearance

Problems in Dealing with the Crisis

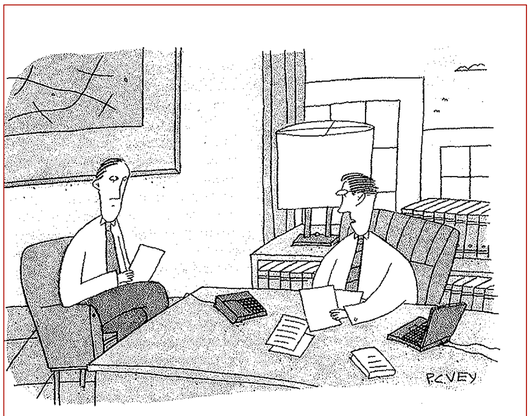
- Lack of Knowledge regarding risk distribution
- National regulators - multinational institutions
- “Safety-net” deficiencies

G20 Finance Ministers Progress Report – Sept 5, 2009

- Macro/lending/trade initiatives
- Governance/resourcing of IFIs and International Cooperation
- Dealing with Tax Havens etc
- Prudential regulation
- Scope of regulation
- Accounting Standards
- Credit rating agencies
- Compensation and remuneration

Limited Liability Implications

- Executive remuneration
  - Leveraged, option-like payoffs and self-determination of volatility
  - Focus on increasing the downside risk?
  - Innovation will avoid upside limits



"These new regulations will fundamentally change the way we get around them."

Limited Liability Implications

- Historically
  - "Super"-liability structures in banking
    - double/unlimited liability
  - Partnerships in investment banking

  Influence governance and risk-taking
- Contingent Capital
  - "callable" debt, partly paid shares, "haircut" schemes

Rethinking International Accords?

- Basel
  - "simple leverage ratio" v risk based capital requirement
- International Accounting Standards
  - Mark to market/model
  - Loan loss provisioning

The "Modern" Bank Run

- Large complex financial institutions
  - Collateralized funding (repos)
  - Wholesale debt/bond market funding
  - Market-making/dealing in derivatives etc
- Liquidity position threatened by
  - Margin calls/Increased collateralization demands
  - Recalls/non-rollover of short term funding
  - Inability to issue into debt markets

The Financial System "Network"

- Stability of a network
  - Connectivity, feedback, uncertainty, innovation
- Understanding the network
  - Identify systemically important institutions
  - Improve information gathering
- Reshaping the network?
  - Central Clearing Counterparties
  - Enforced structural change?

End Users Matter

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Conclusion

Policy Responses to the Crisis

Special measures to stabilise the financial system[1]													
	AU	BR	CA	CH	DE	FR	GB	HK	IT	JP	KR	NL	US
Deposit insurance	✓			✓	✓		✓	✓	✓		✓		✓
Restriction on short selling	✓		✓		✓	✓	✓		✓	✓		✓	✓
Capital injections		✓		✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Debt guarantees	✓		✓		✓	✓[2]	✓		✓	✓	✓	✓	✓
Asset insurance							✓					✓	✓
Asset purchases	✓		✓	✓	✓		✓			✓			✓
Nationalisation					✓		✓					✓	✓

AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; DE = Germany; FR = France; GB = United Kingdom; HK = Hong Kong SAR; IT = Italy; JP = Japan; KR = Korea; NL = Netherlands; US = United States. ✓ = yes; blank space = no.

[1] Reflects information up to end-April 2009. [2] Via the Société de financement de l'économie française.

Source: National data. Table VI.2

Source: Bank for International Settlemetns, 79th Annual Report 2009

Regulatory Funding

- APRA Operating Expenses 2007-8
  - $101.5 **M**ill (or 0.3 basis points per $1 of assets supervised)
- Banking Sector Profits 2008
  - $19.58 **B**ill

Policy Responses to the Crisis

(1) Confidence enhancing measures

- Require shareholders to contribute more equity capital
- Provide Government funding by way of preference share capital or hybrid securities
- Provide Government funding by way of equity capital (partial or full nationalization)
- Guarantee deposits up to some level, and possibly other debt securities newly and/or previously issued by the institution (for a fee).

Policy Responses to the Crisis

(1) Confidence enhancing measures (cont)

- Purchases of "toxic" assets at "fair" prices to be subsequently managed by some official entity, creating a "good" bank.
- Subsidise/partner with private sector purchasers of toxic assets to create a "good" bank
- Provide asset value insurance over toxic assets, protecting the institution against the effects of extreme reductions in their realizable value
- Provide assistance to borrowers/issuers of securities (sub-prime mortgagees, car producers) which increases the fair/market value of those assets.
- Provide credit guarantees on new commercial loans made by financial institutions (although this is primarily focused on expanding economic activity)

Policy Responses to the Crisis

(2) Unfreeze/restore liquidity

- Provide/expand official facilities (repos, discount window, lender of last resort) for institutions to borrow against the security of assets thereby avoiding forced sales at depressed prices.
- Official purchases of assets at "non-fire-sale" prices.
- Introduce securities lending arrangements enabling institutions to lend private securities in exchange for government securities which can be sold to meet temporary liquidity needs
- Use monetary policy to lower interest rates and increase the market value of fixed rate securities (and net wealth increases for those institutions with positive duration gap – assets of longer duration than liabilities)

Policy Responses to the Crisis

(3) Failure management "Bail outs" v failure

- Arrange a merger with a stronger institution (which ideally places a high value on the franchise acquired), by paying compensation for the negative NPV nature of the transaction
- Provide Government funding
- Allow failure of the institution

(4) Temporary Regulations

- Impose restrictions on short-selling to prevent negative equity price movements weakening confidence in the institution
- Freeze, for some period, redemptions by depositors and other liability holders ("bank holidays")

- "There is a limit at which forbearance ceases to be a virtue." Edmund Burke

Policy Responses to the Crisis

(5) Other

- Operate a policy of forbearance, in the hope that the institution will recover
- Allow institutions to adopt accounting techniques which disguise the possible decline in equity value
- Impose "haircuts" on depositors/creditors (partial - possibly reversible subject to institution solvency - conversion of claim to an equity stake)

(6) Macroeconomic stimulus

- Increased Expenditures
- Tax cuts
- Interest rate cuts
- Expansion of money supply

Reasons for regulatory responses

Hypothetical Bank: "T-account"

Assets		Liabilities	
Untarnished	A_1	Deposits	D
Potentially tarnished	A_2	Wholesale funding	B
Tarnished (impaired,"toxic")	A_3	Preference shares	P
		Shareholders equity	E

Financial Crisis Problems

•$E = A_1 + A_2 + A_3 – D – B – P < 0$, Insolvency

•Outflows of D, B force sales of A_2, Potential Insolvency

•Markets for A_2 assets and wholesale funding (B) disrupted

•Stock market valuation of E causing uncertainty

Reasons for regulatory responses

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		Shareholders equity	E

Policy responses

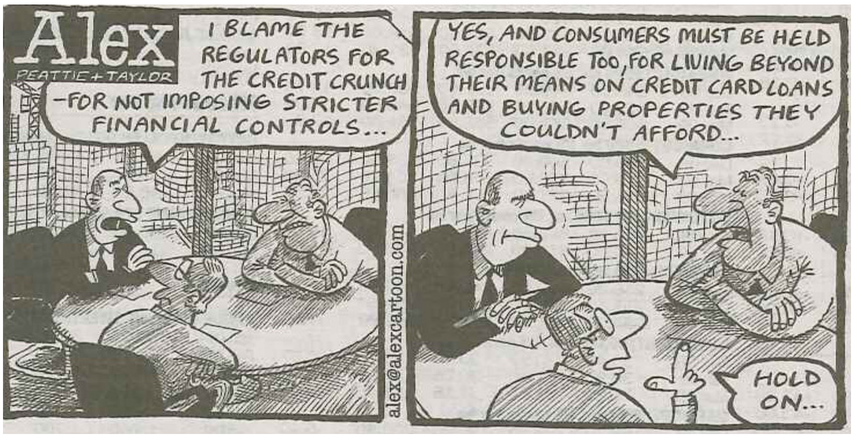
- Enhance confidence (prevent outflows)
- Unfreeze liquidity
- Manage failures
- Temporary regulations
- Other (eg accounting)
- Macroeconomic stimulus

Some General Lessons

- A “belts and braces” response, reflects
  - Unforeseen unfolding of the crisis
  - Lack of knowledge
  - Inadequate “crisis planning”
- Adverse effects
  - Creation of uncertainty (likelihood of government support eg Lehman example)
  - Outflows of funds from non-guaranteed institutions
  - Disruption of business models (eg long-short hedge funds)

Policy Responses to the Crisis

- Criteria for evaluation of policy responses
  - Effectiveness in resolving underlying problem
  - Wealth transfer effects
  - Political/community palatability
  - Conditionality (e.g. lending requirements, dividend restrictions
  - Overlap and duplication
  - Competitiveness effects
  - Ease of exit
- An important research agenda for dealing with future crises


Alex
PEATTIE+TAYLOR
I BLAME THE REGULATORS FOR THE CREDIT CRUNCH —FOR NOT IMPOSING STRICTER FINANCIAL CONTROLS...
alex@alexcartoon.com
YES, AND CONSUMERS MUST BE HELD RESPONSIBLE TOO, FOR LIVING BEYOND THEIR MEANS ON CREDIT CARD LOANS AND BUYING PROPERTIES THEY COULDN'T AFFORD...
HOLD ON...


THESE ARE THE SAME CONSUMERS WHO, AS TAXPAYERS, HAVE HAD TO BAIL OUT THE BANKS. WHEN SEARCHING FOR WHO TO BLAME, DOES IT NOT OCCUR TO YOU THAT WE MIGHT FALL INTO THAT CATEGORY?
DON'T BE SILLY, CLIVE...
I DON'T PAY U.K. TAX...
NO... ME NEITHER... WHY?... DO YOU...?

Some Specific Lessons

1. Consumer financial sophistication/knowledge no match for (designed) complexity of financial products
2. Financial institution incentive/governance structures lead to creation/sales of unsuitable financial products
3. Outsourcing of due diligence/risk assessment failed
   – including reliance on models v humans
4. Large, reputable, financial institutions also try to avoid, and thus undermine, socially justified regulations
5. Bank risk management systems were inadequate
   – problems with measuring risk, control systems, reporting arrangements and governance
6. Non-bank liquidity creation (using collateralized lending) not well recognized or controlled

Some Specific Lessons

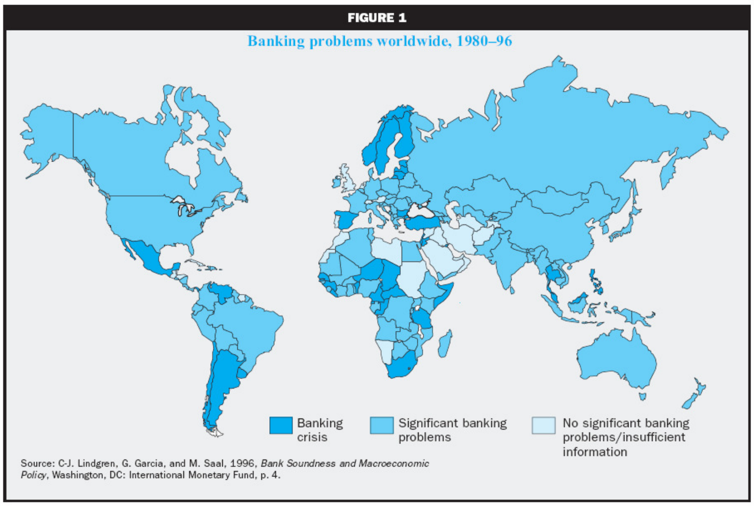
7. Many systemically important TBTF institutions
8. Limited deposit insurance inadequate in crises
9. Asset markets can "freeze" if information deficient
10. Structure of official liquidity support facilities important
11. Risk based capital adequacy requirements insufficiently robust to financial innovation
12. National regulation of multinational institutions (including failure arrangements) extremely complex.
13. "Shadow" banking sector growth complicates prudential, systemic and macro-economic management

The Future for Financial Regulation

- Common themes
  - Despite massive failures, largely a "band-aid" approach
  - No fundamental shift from "market-failure" justification for regulation
    - i.e. inadequate competition, imperfect information, externalities
  - Although increasing recognition of
    - inherent instability of financial markets
    - deficiencies in private sector incentive structures

Crises are frequent!

Financial Crises Post 96
Asian crisis 1997
Russian crisis 1998 (& LTCM)
Brazil 1999
DotCom Bubble 2000
Argentina 2001
GFC 2007-?



A Framework for Reviewing Regulation

- "Economic efficiency" regulation – limits on activities, concentration, operations of markets
  - Some reregulation due to social costs of disruption?
- "Safety" regulation – prudential, systemic, governance
  - Major amendments
- "Information" regulation – contractual integrity, "reasonable" expectations
  - An insoluble problem?

Some Areas of Potential Change

- **"Economic efficiency"**
  - Exchanges
    - Short selling, Insider trading, Rumour-trage
    - Single or multiple markets
  - Market concentration and competition
    - Four pillars
    - financial product supply chain "vertical integration"
  - Public Sector involvement
    - System Liquidity Management and Support
    - Support of particular activities (eg RMBS)

Some Areas of Potential Change

- **“Safety” regulation**
  - Basel II revisions
  - Depositor Protection/Failure Resolution (FCS)
  - “Utility” v “Casino” banking separation
  - Executive Remuneration Policies and Governance
  - Liquidity Management Requirements
  - Scope of Regulation
  - International Collaboration
  - OTC Markets v Exchanges and CCCPs

Some Areas of Potential Change

- **“Information” regulation**
  - Mark to Market accounting
  - Role/regulation of CRAs
  - ASIC
    - “swimming between the flags” approach
    - “if not why not” disclosure
    - External Dispute Resolution schemes
    - National Consumer Credit Code
    - Adviser Fee arrangements
- Effectiveness of Education, Advice, Disclosure approach versus alternatives

Regulatory Structure

- Australian regulatory structure performed well
  - Although ASIC's "oversight/enforcement" mandate couldn't prevent growth of flawed business models
  - APRA/ASIC merger unlikely
- Increased importance of macro-prudential policy and systemic stability issues raises question of RBA/APRA separation
- Increased importance of international regulatory collaboration

Questions