Dialogue on Globalization

BRIEFING PAPERS
FES NEW YORK

How To Create Better Financial Regulation & Institutions

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1 Introduction

It is useful to put crises and responses to them into a historical context. Firstly, it is important to stress that after the Great Depression, the financial sector – particularly, but not only, in the US – was re-regulated carefully, most notably by the Glass-Steagall Act of 1933. During the next 40 years, the financial sector was closely regulated, capital accounts were essentially closed, and there were practically no financial crises.

Since the 1970's, and especially during the 1980's and 1990's, there has been far-reaching deregulation, both at national and international levels. Since the 1980's, there have also been frequent and deep financial crises, both in the developing and developed world. These crises have been extremely costly in terms of growth and development. Barry Eichengreen (2004) gives the staggering estimate that over the last quarter of a century, currency and banking crises have reduced the incomes of developing countries by 25 percent.

The fact that even *Japan's* GDP fell 12% over the last three months of 2008 shows how serious the impact of the current global crisis is on the real economy. Though crises have complex causes, it is evident that the liberalization of financial markets, especially if not accompanied by appropriate regulation, seem almost always to lead to costly and damaging crises. This implies that financial crises are not inevitable, but rather, may be prevented or ameliorated by appropriate public policy, and especially by regulation.

The only silver lining that appears during these costly crises — such as the current one — is that they provide a political opportunity to carry out desirable regulatory reforms. The task of improving regulation is urgent because the political window of opportunity is narrow and can close quickly, once the crisis diminishes. This was, for example, an important lesson learned in the wake of the East Asian crisis. Even though there was a major debate both during and after the crisis about reforming the international financial architecture, including its regulatory structures, in practice very little progress was actually made once the crisis was contained, especially in the developed economies (Griffith-Jones and Ocampo, 2003).

However, the current crisis originated — and is extremely deep — in the developed economies, and particularly in the United States. It has led to massive bailouts and costly public recapitalizations of many financial institutions in those countries, at great cost to their taxpayers. The crisis threatens to lead to a serious and long recession in developed countries and globally. As a consequence, there is a political appetite for more and better regulation. It is increasingly clear that effective regulation is not only in the interest of the real economy, but also safeguards the stability of the financial system itself — as well as its individual financial institutions. Moreover, for a country to have a competitive financial system, it must be well regulated. Indeed, steps are beginning to be taken to improve regulation, for example, by making it more comprehensive.

The key question in policy circles at present is therefore not whether to regulate, but how best to do it. In thinking about the future shape of the financial system and its regulation, it is important to be clear about its purpose. The financial sector should be seen as a means to an end; it should serve the real economy, and thus the needs of households and enterprises to consume and invest. Governments should encourage the financial sector to create financial innovations and instruments that support growth and development in a sustainable way. It is particularly important that governments utilize regulation to avoid the generation of systemic risk, so that future crises — which can be profoundly negative for the real economy — can also be avoided.

Inherent flaws in the way that banking and capital markets operate leads to a boom-bust pattern that is linked — as market participants themselves describe it — to cycles of greed and fear. These pro-cyclical processes lead in turn to the main kind of failure in these markets. The second major cause of crises — as briefly mentioned above — is rapid liberalization within and across countries, a process accompanied by insufficient, incomplete and inappropriate financial regulation. Indeed, the

excesses of financial liberalization, coupled with major mistakes of regulation, as well as incomplete regulation, have led to a historic policy failure.

2.1 Principles of Regulation

To overcome the failures — of both markets and policy — that have been major factors contributing to the crisis, two key principles of regulation need to be followed. The first principle is comprehensiveness: the domain of regulation needs to be the same as the domain of the market. The second is counter-cyclicality, which must be placed at the heart of regulation.

2.2 Comprehensiveness

Financial systems — both nationally and internationally — have undergone very large changes in the past ten years. Regulation has clearly not kept up. In the United States, and also in other developed countries like the UK, there has been a huge shift of savings from banks to capital markets. As noted in d'Arista and Griffith-Jones (2008), only 25% of the US financial systems' assets belonged to commercial banks in 2007.

Worsening matters, commercial banks are the only part of the financial system that has been regulated for capital requirements, and even that regulation is partial, as off-balance sheet instruments such as structured-investment vehicles have been practically unregulated. Investment banks have been very lightly regulated, while other financial actors — like the powerful rating agencies, mortgage lenders, and hedge funds[1] — have been subject to no regulation at all. For some of the financial instruments, like over-the-counter (OTC) derivatives, which grew to astronomical levels — more than any other instrument in the last decade — there was no transparency and even less regulation. In addition, off-shore centers remain subject to extremely light or no regulation at all.

As a consequence of this hands-off regulatory system, a massive "shadow financial system," seriously deficient in both transparency and regulation, was allowed to emerge. Indeed, regulatory arbitrage – a practice designed to get around regulations – encouraged the growth of financial activity and risk taking. In fact, many of the very problems that caused the financial crisis arose in institutions (e.g. mortgage lenders) and instruments (e.g. credit default swaps) that were unregulated. This is a lesson that should have been learned from previous financial crises in developing countries, where the most liberalized and unregulated parts of the financial system were the source of crisis.

In capital markets, there has been practically no formal regulation. Private actors, such as insurance companies, boldly acted as though they were entitled to sell systemic risk insurance, like credit default swaps (CDS). Some of those major insurance companies, like AIG in the US, had to be rescued and effectively nationalized, as they became bankrupt during the crisis. This came about because they did not have sufficient capital and reserves to fulfil credit swap insurance contracts that carried enormous systemic risk. Indeed, no entity — except the government — was capable of credibly fulfilling such a contract once the crisis spread. Thus, the government not only became lender of last resort, but also insurer of last resort, since it had not previously exercised regulation to limit the risk that afterwards it had to assume.

To summarize, regulation has to be comprehensive so that the domain of the regulator will be the same as the domain of the market; otherwise, regulatory arbitrage is inevitable. Another reason for comprehensive regulation — as illustrated by recent events, when bailouts and rescues have become extensive — is the need to avoid moral hazard, in other words, placing the appropriate consequences for risky behavior upon those who cause the risk.

[1] Germany raised the issue of regulating hedge funds even before the global crisis. This discussion became more intense, for example in the European Parliament and the European Commission, after the crisis started.

It is perhaps obvious that a necessary pre-condition for effective comprehensive regulation is comprehensive transparency. Thus, over-the-counter derivatives should all be brought onto the exchanges (even if this produces certain microeconomic costs). Off-balance sheet instruments, like structured-investment vehicles, should be brought onto the balance sheets, and on-site inspection of banks and other financial institutions should be expanded. This process should be facilitated by the fact that, in developed countries, governments own capital.

Comprehensive regulation should relate both to liquidity and solvency. Regarding solvency, equivalent regulation of different actors, instruments and activities should aim at uniform limits on leverage, as excessive leverage has been a major source of systemic risk. However, as the longevity of funding is an important variable, it may be desirable to restrict leverage (and require more capital) for assets funded by short-term liabilities. This will not only protect the solvency of financial institutions but also encourage them to seek more long term funding. Separate minimum liquidity requirements should be an essential part of regulation, an aspect that has been neglected in recent years.

2.3 Counter-Cyclicality

Historically, the most significant financial market failure comes when these markets operate with pro-cyclicality. In fact, risk is generated mainly in the booms, even though it becomes apparent in the busts. Therefore, the time for regulators to act — to prevent excessive risk taking — is precisely in the boom. Indeed, one of their key functions is to take away the "punch-bowl" when the party is at its best.

As a consequence, financial regulation needs to follow the principle of counter-cyclicality, which implies "leaning against the wind." This should be facilitated by simple rules that cannot be easily changed by regulators so that they themselves will not become captured by "boom-time" enthusiasm and thereby relax regulatory standards. In fact, under Basel II, bank regulation does exactly the opposite, particularly in the set of credit risk measurement techniques known as the "Advanced Internal Rating Based" (A-IRB) approach, in which required capital is calculated based on the banks' own models. This perversely incorporates the inherent pro-cyclicality of bank lending into bank regulation, thus accentuating boom-bust patterns.

Counter-cyclical bank regulation — of provisions and/or capital — can be easily introduced, either through banks' provisions or via their capital. Counter-cyclical bank provisions have already been used for some time in Spain and Portugal, which shows the feasibility of the strategy. The Spanish system requires higher provisions when credit grows more than the historical average, thus linking provisioning to the credit and business cycle. This both discourages (though does not eliminate) excessive lending in booms and strengthens the banks for bad times. The introduction of counter-cyclical provisions in Spain was facilitated by the fact that the design of accounting rules falls under the authority of the Central Bank of Spain. Unfortunately, accountants in many other countries do not readily accept the concept of "latent" or expected losses, on which the Spanish system is based, preferring instead to focus on actual losses, information that is more relevant for short-term investors. However, accounting principles should be designed in ways that balance the short-term needs of investors with those of individual-bank and systemic banking-sector stability.

An alternative approach for counter-cyclical bank regulation is through capital. Here, Goodhart and Persaud (2008) have presented a specific proposal: increase Basel II capital requirements by a ratio linked to the recent growth of total banks' assets. This provides a clear and simple rule for introducing counter-cyclicality into the regulation of banks. Another virtue of this proposal is that it can be fairly easily implemented, since it builds directly on Basel II. It also has the advantage that it does not face the accounting difficulties outlined above for provisioning. In this proposal, each bank would have a basic allowance of asset growth, linked to macroeconomic variables such

as inflation and the long-run economic growth rate. It would measure the actual growth of bank assets as a weighted average of annual growth (with higher weights for recent growth).

Two issues then arise. Should the focus be just on the increase in total bank assets, or should there also be some weighting for the excessive growth of bank lending in specific sectors that have themselves grown particularly rapidly (such as recently to real estate)? Often crises have arisen due to excessive lending to particular sectors or countries (e.g. emerging economies) during boom times. However, most systemic bank failures have also been preceded by the excessive growth of total bank assets.

Finally, there is the crucial issue of timing. It is important to approve such changes soon, while the appetite for regulatory reform remains high. However, reforms should be introduced with a lag, so as to avoid increased capital requirements (especially linked to the weighting given to growth in recent years in the Goodhart-Persaud formula, which would be high) thereby putting pressure on currently weak banks and accentuating the credit crunch. Make no mistake, leverage has to be reduced when it builds up, but this should be done gradually and in a controlled fashion, to avoid disasterous social consequences.

Some of the least regulated parts of the financial system may have some of the strongest pro-cyclical impacts, including on emerging economies. One such example is the role that hedge funds and derivatives play in the carry trade; there is increasing empirical evidence that such carry trade has very pro-cyclical effects (on over- or under-shooting) of the exchange rates of both developed and developing economies, with frequent negative effects on the real economy. For regulation to be comprehensive, as argued above, there should be minimum capital requirements for all derivatives dealers and minimum collateral requirements for all derivatives transactions, so as to reduce leverage and lower systemic risk. Collateral requirements for financial transactions function much like capital requirements for banks.

Another important issue to explore is whether the regulation of derivatives' collateral and capital requirements should also have counter-cyclical elements. This would seem desirable and would imply that when derivative positions, either long or short, are growing excessively (for example, well beyond historical averages), collateral and capital requirements would be increased.

3 Regulating Bankers' Compensation

Another way to discourage counter-cyclicality is to regulate the compensation of bankers and other market actors. As Stiglitz (2008) points out, incentives are at the heart of the boom-bust behaviour of financial and banking markets. A large part of bonuses are tied to short term profits: they are positive in good times but never negative, even when big losses occur. This encourages bankers and fund managers to take a lot of risk in boom times which results in high bonuses for them. However, they will not lose money if heavy losses are incurred later due to their excessive risk-taking in good times, even though systemic risk also increases, as is recognized even by the Institute of International Finance (an organization that represents the major banks).

There is another negative effect of short term bonuses that is less often highlighted. In good times, a large part of profit is paid out as bonuses. Because this profit is taken out of the banks, it is therefore not used to increase their capital, such that when crises come, banks are recapitalized by bailouts ultimately paid by tax-payers. It can be argued that taxpayers are paying after the fact for excessive bonuses.

The political point can be made that high bonuses and high remunerations contribute to the concentration of great wealth in the financial sector. As a consequence, financial actors gain political influence, for example by financing political campaigns. The increased wealth and influence of the financial industry may thus increase the risk that their regulators become captured, or hired at greater salaries into higher-paying sector jobs. The simple solution to this problem is that bankers and fund managers

receive a fixed salary. Bonuses could either be abolished (a more radical solution) or accumulated into an escrow account, in which case they could be cashed only after a period equal to an average full cycle of economic activity, if the activity it is compensating remains profitable. Such a change would reduce existing incentives towards short-termism.

Either individual firms or the financial industry as a whole could introduce such changes, as stability is in their own long term interest. However, collective action and principal agency problems makes this highly unlikely. As a consequence, the outside regulation of compensation schemes may be the best way forward, even from the perspective of the stability of individual financial institutions. This would be particularly beneficial for systemic financial and macroeconomic stability. It is encouraging that the Financial Stability Forum is studying the introduction of a code of conduct on compensation schemes and requiring higher capital from banks that do not confirm with it.

4 Institutional Arrangements

In terms of new institutional arrangements for regulation, there are necessary changes at both national and international levels. Part of a new regulatory structure in the US at the national level should be a financial products safety commission. (Stiglitz, 2008). This commission would assess the benefits and risks of particular products and determine their suitability in general and for particular users. In so doing, it would have strong parallels with the Food and Drug Administration, which evaluates the risks and benefits of new medications. There is a clear rationale for this in financial markets as well. Financial markets have innovated, but often these innovations have been damaging for individuals, financial institutions and the whole economy. Clearly, the financial sector has not done a good job at analyzing the consequences of the products they produce. Defective products can have disastrous effects both on those who buy them and on the economy, as they can create systemic risk.

A financial products safety commission could evaluate products, especially those being produced and invested in by regulated entities. Each product would have to have a stated objective (e.g. In what ways does it help manage and mitigate risk? What is the risk profile for whom the product is intended?). Its risk characteristics would be identified using conservative models that paid due attention to the failures that characterize financial markets. Such a commission would determine whether individual products provided significant risk mitigation benefits of the kind purported by the product. There would be a presumption that there is “no free lunch”, in other words, higher returns can be obtained only at the expense of greater risk. There would also be a strong presumption against complex products, the full impact of which are hard to analyze. A financial products safety commission would establish transparency standards that all those dealing with regulated financial entities (including hedge funds) would have to satisfy. It would have the power to ban certain products from the balance sheets of regulated entities and would also look at the pricing of those products.

A well designed regulatory system needs to be comprehensive, otherwise funds will flow through to the least regulated part. That is why there is a need, within individual countries, for a financial *markets* stability commission which would have oversight of the entire financial system and would provide integrated regulation of each of the parts of the system. (See Stiglitz, 2008). Such a commission would also look carefully at the interrelations among the parts of the system.

Modern financial markets are complex, with many and often unexpected interrelations among different institutions of different kinds, as shown in the current crisis. A financial market stability commission could assess over-all risks, looking at the functioning of the entire financial system and how it would respond to various kinds of shocks. In a complementary fashion, a financial products safety commission would look at individual products and judge their appropriateness for particular classes of purchasers. A financial market stability commission would have been charged

with identifying macroeconomic risks, for instance, the risk posed by the breaking of the housing bubble. All of the regulatory authorities (those regulating securities, insurance, and banking) would then report to the commission. With oversight over the entire system a financial market stability commission would help to avoid regulatory arbitrage.

At the international level, there is also a need for designing an institutional structure consistent with the fact that capital and banking markets have very large parts that operate globally. For the domain of the market to be with the same as the domain of the regulator — to thus avoid regulatory arbitrage between countries and financial centres — it would be desirable to have a global financial regulator. Both academics (Eatwell and Taylor, 2002) and some market actors have long called for such an institution, but the recent crisis — and the way contagion has spread throughout the globe, affecting even countries with sound financial systems — has made a global regulatory institution more necessary and politically more feasible.

A global financial regulator would design standards to be applied by all countries and jurisdictions, including offshore centres. Parts of the financial system with no global connections, e.g. small banks that lend only to farmers in a particular region, could be still regulated nationally. However, financial institutions with any international connections should be regulated by the global regulator and the standards it designs.

A key question is whether a *new* institution should be created to fulfil this function. Given the difficulty of achieving the necessary consensus to create new international institutions, it may be desirable to adapt an existing one, namely, the Bank for International Settlements (BIS). The BIS is the leading candidate for at least three reasons: its concern with regulating systemic risk in financial markets, the high quality of its analysis, and its close links with central banks and regulatory bodies.

However, an absolutely necessary pre-condition for the BIS to provide a basis for a global financial institution is that its membership become more universal and that developing countries be duly represented in its Board, management, and staff. Accountability of government representatives of the BIS to their Parliaments would also be important. Developing countries should be adequately represented to appropriately reflect their weight in the world economy, as indicated by the magnitude of their financial assets, their contribution to world savings and their level of foreign exchange reserves. Such an expansion of membership — providing for representatives of regions that in turn represent smaller and poorer countries — is key to establishing multilateral credibility.

Furthermore, important elements from the Financial Stability Forum (FSF), to which the BIS provides a secretariat, should be incorporated into a global regulator. There should naturally be close interaction with the IMF on the macroeconomic aspects of risks, both globally and at a country level, (a subject also studied by the BIS). However, the IMF should *not* become the global regulator, as the institution already has many important functions to fulfil — which it needs to do more fully than at present — and it has limited expertise in the design of regulatory standards, regulation and supervision, especially at a global and developed country level. Furthermore, the IMF has been — at least in the past — too closely wedded to excessive enthusiasm for the deregulation of financial markets to give it credibility at present.

It is encouraging that the G-20, in their November 15, 2008 Declaration, called urgently for an expansion of the Financial Stability Forum to a include a "broader membership of emerging economies, and other major standard setting bodies should promptly review their membership". The urgency of such an expansion cannot be underestimated, as developing countries are not at all represented in these bodies (which are therefore extremely undemocratic at present). Ultimately, such reforms would ensure not only greater legitimacy but also greater efficiency. Last, but not least, some representation of the non-financial part of the economy could be valuable,

for example with some representation by business and trade unions.

Finally the importance of conferring a global regulator with real power to influence the decisions of national regulators, especially in all the large economies whose financial systems have a systemic impact on the world economy cannot be underestimated. Such centrality will be difficult to achieve, given that countries are loathe to concede sovereignty to international bodies. Nevertheless, the case can be increasingly made that countries would also gain sovereignty by increasing their control over the global financial system, over which they have limited control at present.

In conclusion, the design and creation of a global financial regulator is one of the main institutional challenges that the international community faces in the wake of the current financial crisis. Such a body would allow regulatory reforms to be implemented globally, thus curtailing regulatory arbitrage. It would also help to prevent future crises. The other option — to make capital and banking markets less global by introducing capital controls — is a less attractive strategy at present. However, the segmentation of global markets, for example by introducing capital controls, may take place on its own if effective global regulation is not introduced. Thus, those who favour financial globalization should be strong supporters of a global financial regulator.

5 Appendix (Resources/Publications)

D'Arista, J. and Griffith-Jones, S. (2008) "Agenda and Criteria for Financial Regulatory Reform." Working paper for Initiative for Policy Dialogue.

Eatwell, J. and Taylor, L. (2002) *International Capital Markets: Systems in Transition*. London: Oxford University Press.

Eichengreen, B. (2004) "Global Imbalances and the Lessons of Bretton Woods." NBER Working Paper 10497. Cambridge: National Bureau of Economic Research.

Goodhart, C. and Persaud, A. (2008, January 31). "A Proposal for how to Avoid the Next Crash". Financial Times, p. 9.

Griffith-Jones, S. and Ocampo, J. A. (2003) "What progress on international financial reform? Why so limited?" EGDI Sweden.

Stiglitz, J.E. (2008) Testimony before the House Committee on Financial Services, October 21, 2008.

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