Financial Regulation Going Forward

Franklin Allen
University of Pennsylvania

Elena Carletti
European University Institute

Bank of Japan
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What caused the crisis?

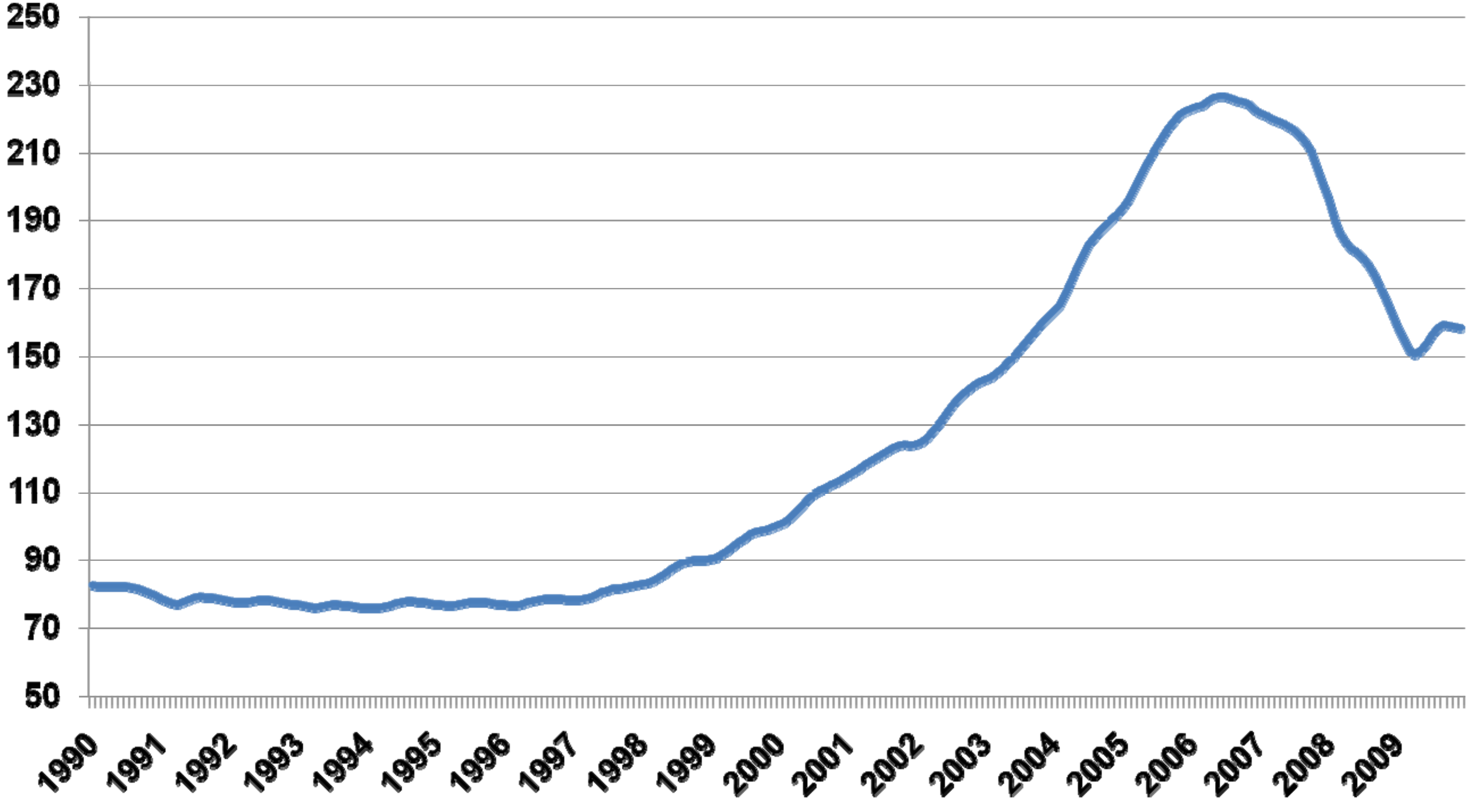
- The conventional wisdom used to be that the basic cause of the crisis was bad incentives in the mortgage industry

But now we know much more was going on…

- The large global impact of the crisis suggests that the problems with subprime mortgages were a **symptom** rather than the cause

- The main problem is that there was a **bubble** in property prices in the U.S., Spain, Ireland and elsewhere, and we are now suffering the fallout from the collapse of that

Current Crisis:
Case-Shiller 10 Cities Composite



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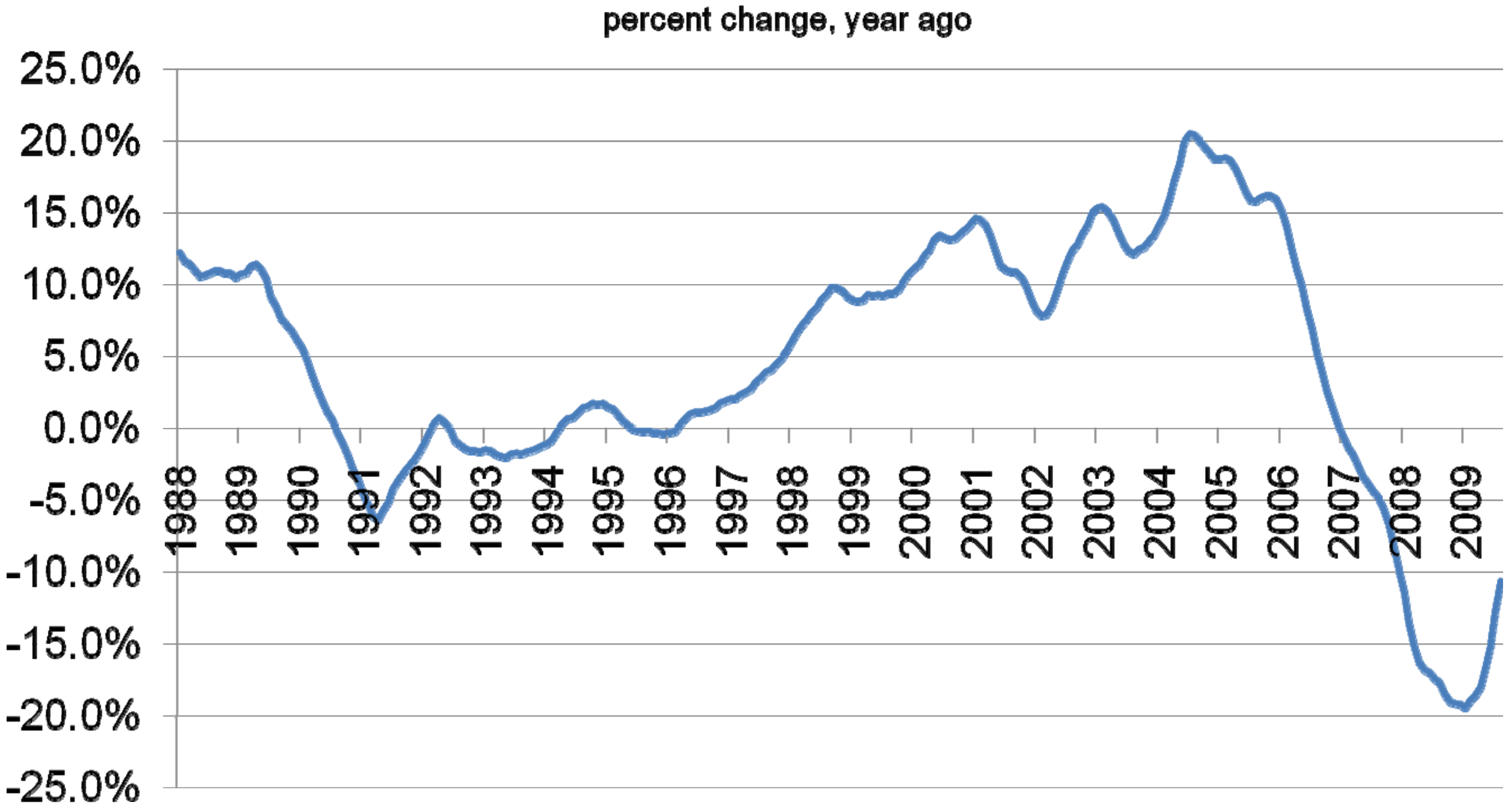
Percentage Change in Case-Shiller 10 Cities Composite



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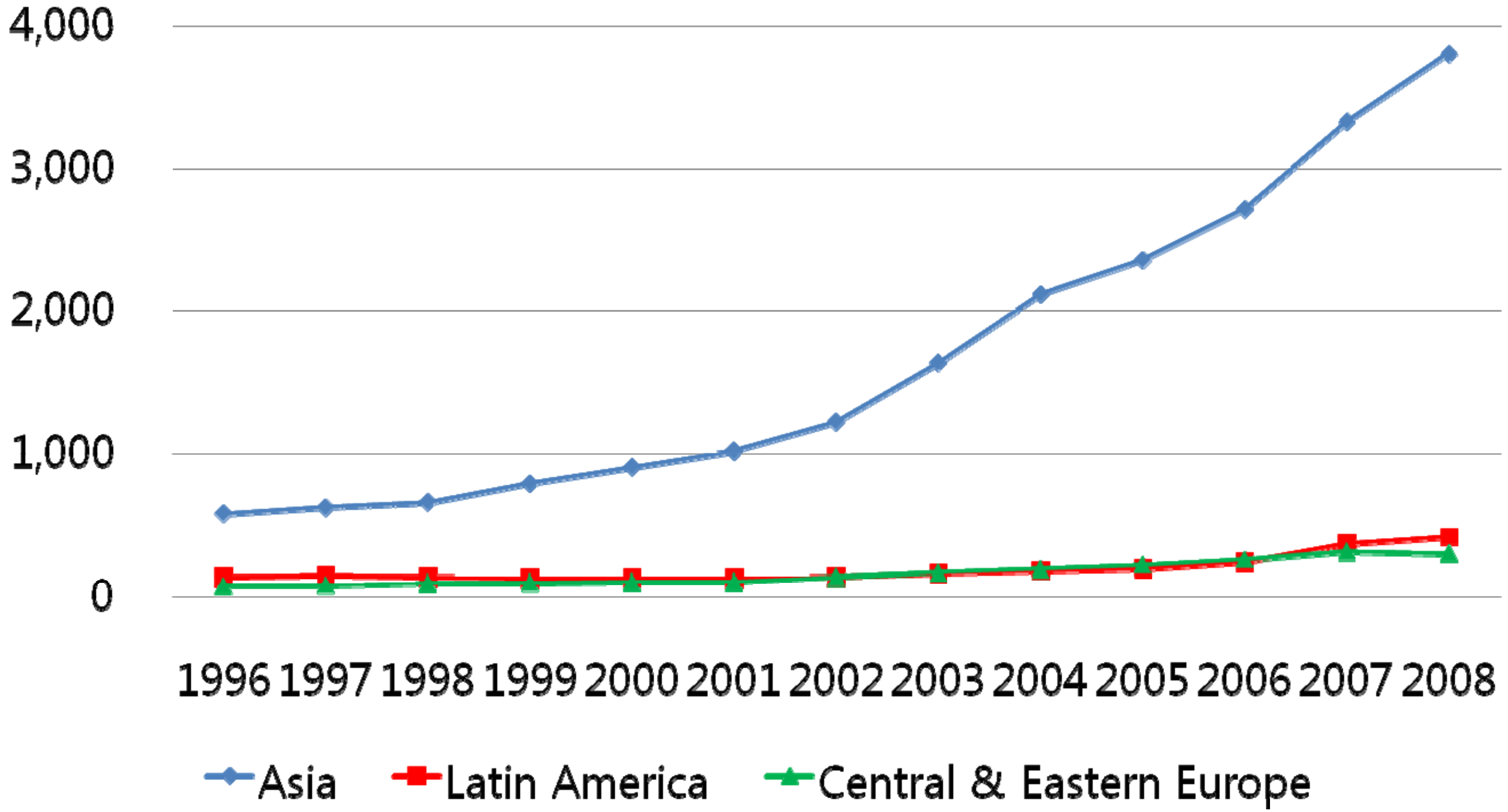
What caused the bubble?

- The monetary policies of central banks particularly the U.S. Federal Reserve and ECB in some countries were too loose – they focused too much on consumer price inflation and ignored asset price inflation

- Global imbalances – the Asian crisis of 1997 and the policies of the IMF led to a desire among Asian governments to acquire reserves

Reserves: A Comparison



To summarize:

- The first aspect of the problem was the development and bursting of the property bubble

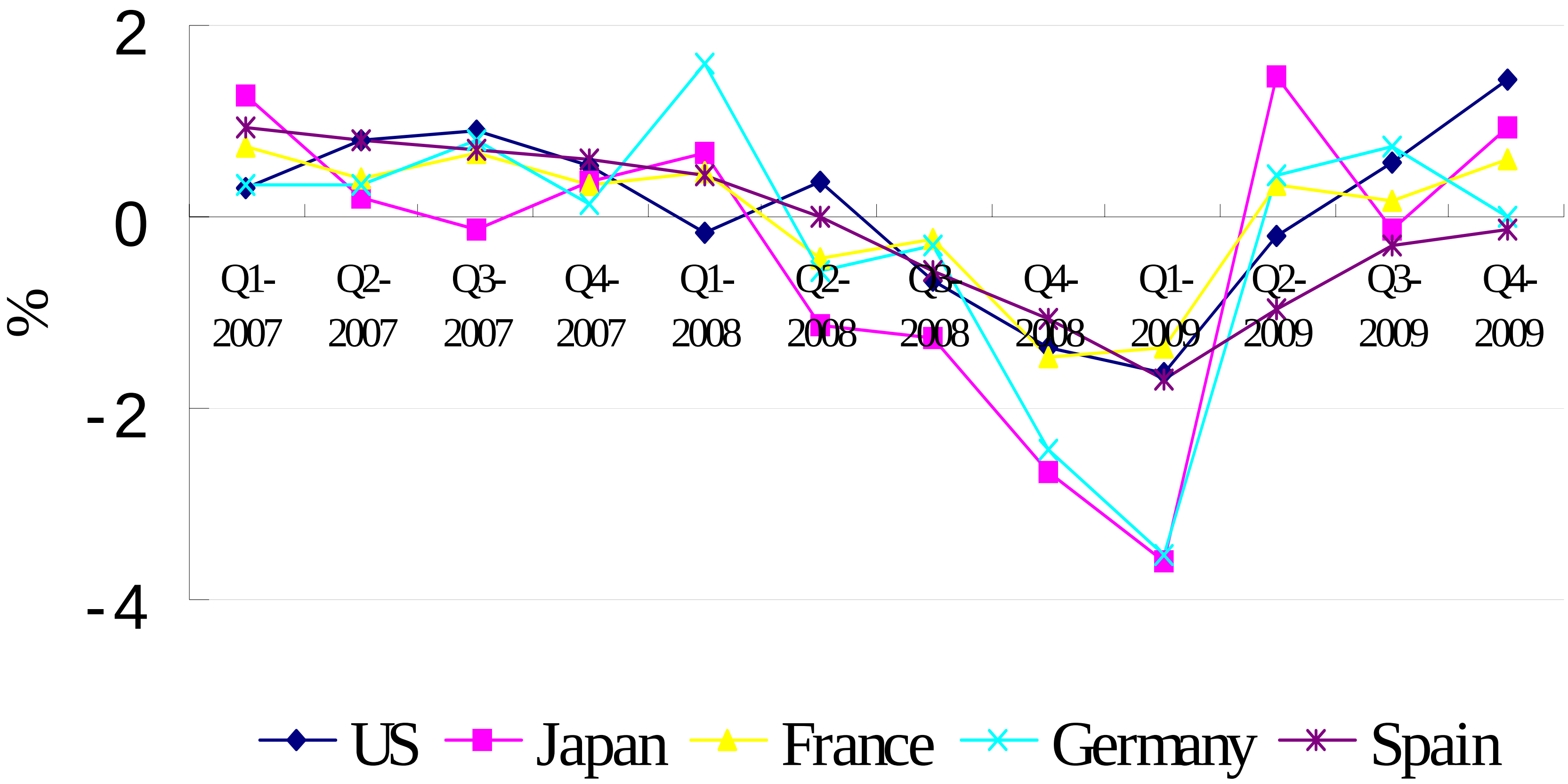
- The second aspect was that this problem was considerably exacerbated by the poor functioning of the financial system in the crisis

- How much of the disruption to the real economy is due to the bursting of the bubble and how much is due to the financial crisis?

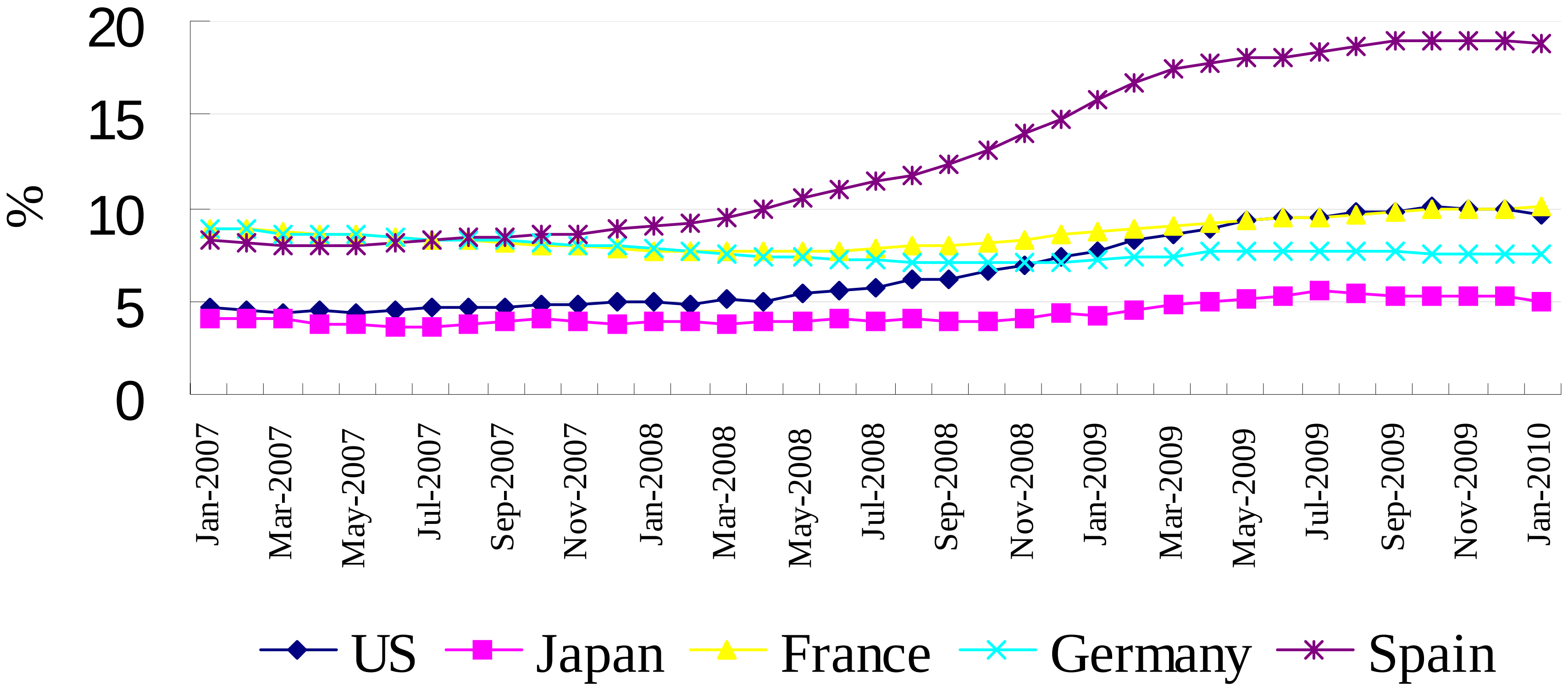
Spain

- One of the largest property bubbles occurred in Spain
- The bursting of this bubble has devastated the real economy – unemployment has doubled to a level of almost 20%
- BUT the financial system, and in particular the banks such as Santander and BBVA have come through the crisis very well until the problems in Greece
- This suggests that the bursting of the bubble can cause tremendous damage to the real economy even if the financial system remains strong

% in quarterly GDP quarter on quarter



Unemployment



Why has the financial system performed so poorly?

- Why didn’t regulation help?

- Banking regulation is different from other kinds of regulation in that there is no wide agreement on the market failures it is designed to correct

- It is backward looking in the sense that it was put in place to prevent the recurrence of past types of crises

Policy responses

- Banking regulation needs to focus on correcting market failures rather than being imposed ad hoc as has been done historically

- Central banks and governments need to be much more focused on preventing bubbles and global imbalances than in the past – this is the real cause of the crisis

- The international financial architecture needs to be reformed

Regulation

- What are the benefits and costs of regulation?
- The Basel agreements illustrate the lack of a widely agreed theoretical framework
- What exactly are important the market failures?
  - Panics
  - Contagion
  - Mispricing due to limits to arbitrage

Banking regulation

- Capital regulation main tool for regulation in recent years
- What are the market failures this regulation is solving?
- Basel agreements are silent on this issue
- Contagion is one of the most important market failures capital regulation can help prevent

Banking regulation (cont.)

- What is the cost of capital buffers – i.e. why is equity more costly than other forms of finance?
- Most plausible explanation of the high cost of equity finance is that there is a tax subsidy to debt in the form of interest deductibility
- If this is the case then the best policy is to remove the interest deductibility of debt so that large capital buffers are both privately and socially optimal – it is not clear there is any good justification for the tax deductibility of interest

Systemically important financial institutions

- “Too big to fail” is not “Too big to liquidate”
- The government needs to guarantee the short term commitments of failing banks to prevent contagion
- When a bank fails or is close to failure the government should step in, take it over and resolve it
  - the top 5 executives should be removed immediately
  - all employee pension claims should be eliminated
  - over the next few years the bank should be liquidated
- International issues

Resolving large cross-border financial institutions

- Eliminate cross-border branches and require subsidiaries

- Regulators should monitor the degree of mismatch between assets and liabilities within the country with significant mismatches leading to posting of collateral

- Large equity buffers of 20 percent in terms of accounting and market capital

- Banks resolved when equity falls below 5 percent

Limits to arbitrage and the mispricing of assets

- Many people believe that prices of securitized products broke free from fundamentals and this is why prices fell so low

- TARP and many other plans were designed to restore prices to their proper level – more effective policies need to be developed to ensure asset prices reflect fundamentals

- Mark-to-market versus historic cost accounting

Competition in financial services

- There is much discussion about bankers' compensation but the real issue is how banks are able to make so much money that they can pay such high compensation

- What is really needed is a **full competition review** that establishes how they make so much money
  - Market structures that are anticompetitive?
  - Front running in the bond market?
  - Conflicts of interest – e.g. Goldman Sachs
  - Swapping privileged information about takeovers and so forth with other institutions to make high profits on their proprietary trading?

Reform of central banks

- Central bank independence works well for combating inflation but not for financial stability
- The private sector is being criticized for taking so much risk but it is really the Federal Reserve, ECB and other central banks that took the risks, e.g. low interest rates in 2003 and currently quantitative easing
- There needs to be some check and balance mechanism such as a Financial Stability Board that helps to control **public sector risk taking**
- Macroprudential measures

Global imbalances

- Self-insurance by Asian countries through large reserves is optimal for them, e.g. South Korea
- However, it is a very inefficient mechanism from a global perspective
- Reform of the IMF? Global currency?
- Regional risk sharing
- Bilateral swaps to give foreign exchange safety net
- Rmb as a reserve currency

Other measures

- Reform of derivatives market structures
- Size and activity caps
- Consumer protection
- Limits on leverage
- Public sector banks