



International Centre for
Financial Regulation

Annual International Regulatory Summit

**Regulation Without Borders – G20 Ideals and National
Interests**

www.icffr.org



International Centre for
Financial Regulation

Wasting the crisis:

The G20's Role in Financial Sector Reform

Richard Portes

www.icffr.org



Wasting the Crisis: The G20's Role in Financial Sector Reform

Richard Portes

London Business School and CEPR

*ICFR Annual International Regulatory Summit
Amsterdam, 8 November 2010*



Road map

- The G20 pledges
- Banks
- Markets
- Why the pledges won't be fulfilled
- But some potential good news

G20 objectives (November 2008)

- *Intensified international cooperation among regulators and strengthening of international standards...[are] necessary to protect against adverse cross-border, regional and global developments...*
- *Regulators must...support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage...*
- *Regulators ...should develop recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends...*
- *...review resolution regimes and bankruptcy laws...to ...permit an orderly wind-down of large complex cross-border financial institutions...*
- *...ensure that credit rating agencies ... avoid conflicts of interest [and] provide greater disclosure*
- *...speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms...*
- *...develop robust and internationally consistent approaches for liquidity supervision of...cross-border banks...*
- *Financial institutions should...avoid compensation schemes which reward excessive short-term returns or risk taking...*



Results

- Action on issues that are economically unimportant but have political payoff
- Dodd-Frank and European counterparts
- Banks
 - size and structure
 - regulation of individual banks - microprudential
 - resolution regimes
 - macroprudential regulation
- Markets
 - OTC derivatives
 - ratings agencies



A new environment

- Volatilities much higher – won't return to pre-July 2007 – higher uncertainty, more uncertainties, than in living memory
- Now clear that liquidity can be ephemeral, counterparty risk can be ubiquitous – but not clear we know how to deal with this properly
- Will this round of (re-)regulation be as successful as 1933-34?
- There will always be crises – they are all the same, in a deep sense, but the next one will be different in practice (we are now on 'fourth generation' crisis models)



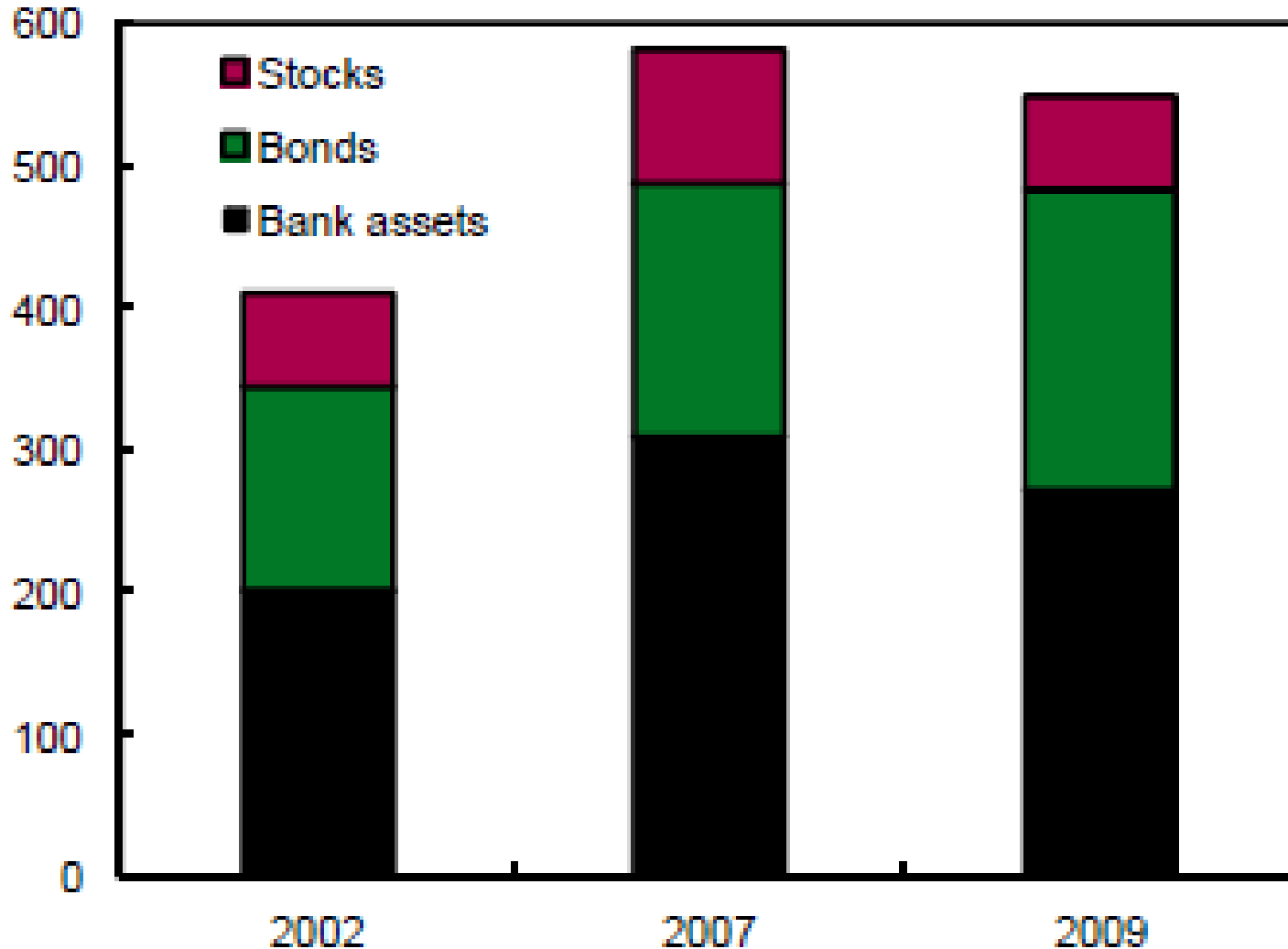
Action – but little to do with the crisis

- tax havens and money laundering (why weren't they shut down before?)
- Is there any evidence that hedge funds or private equity had any significant role among causes of the crisis?
- The European Union's Alternative Investment Fund Managers directive is crude, protectionist, a distraction (though better than the original version)

Here is the issue...

Size of the financial sector (% of GDP)

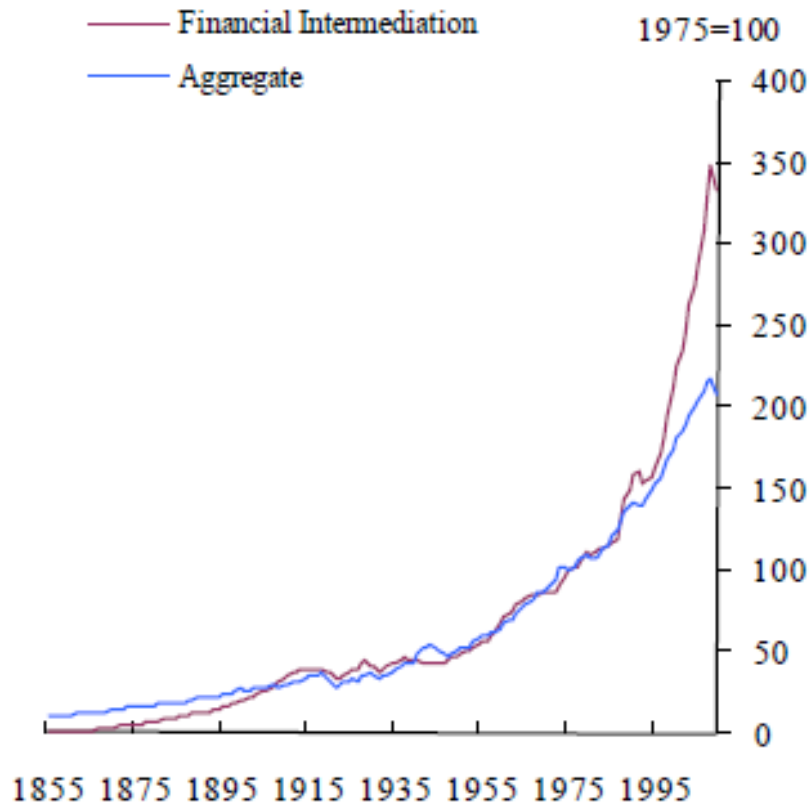
European Union



Source: IMF, 'Shaping the new financial system', SPN/10/15, 3 October 2010

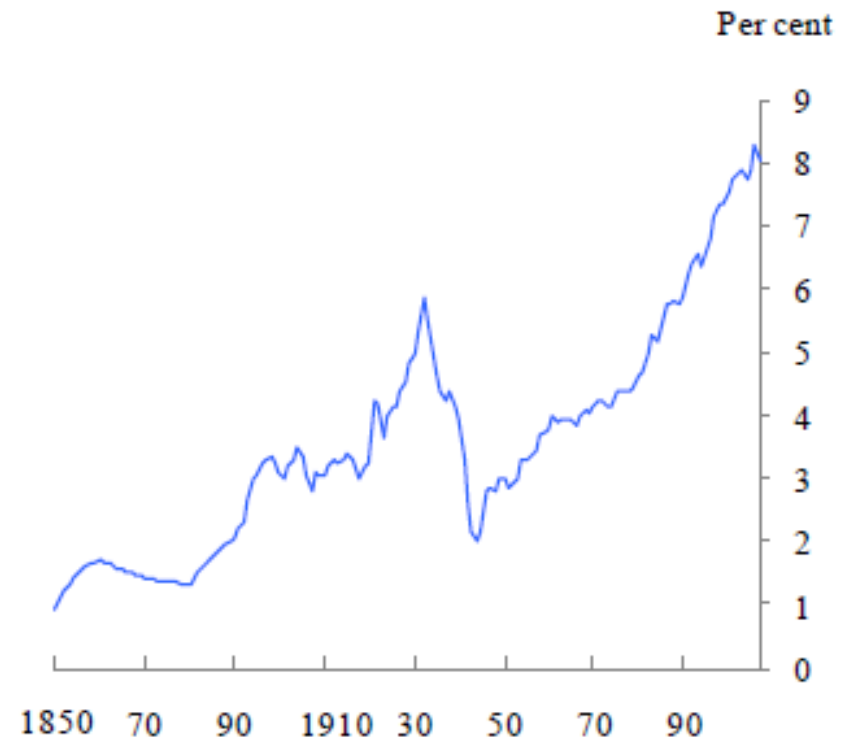
Extraordinary expansion with deregulation

Chart 1 UK financial intermediation and aggregate real GVA



Sources: Feinstein (1972), Mitchell (1988), ONS and Bank calculations.

Chart 3 Share of the financial industry in US GDP

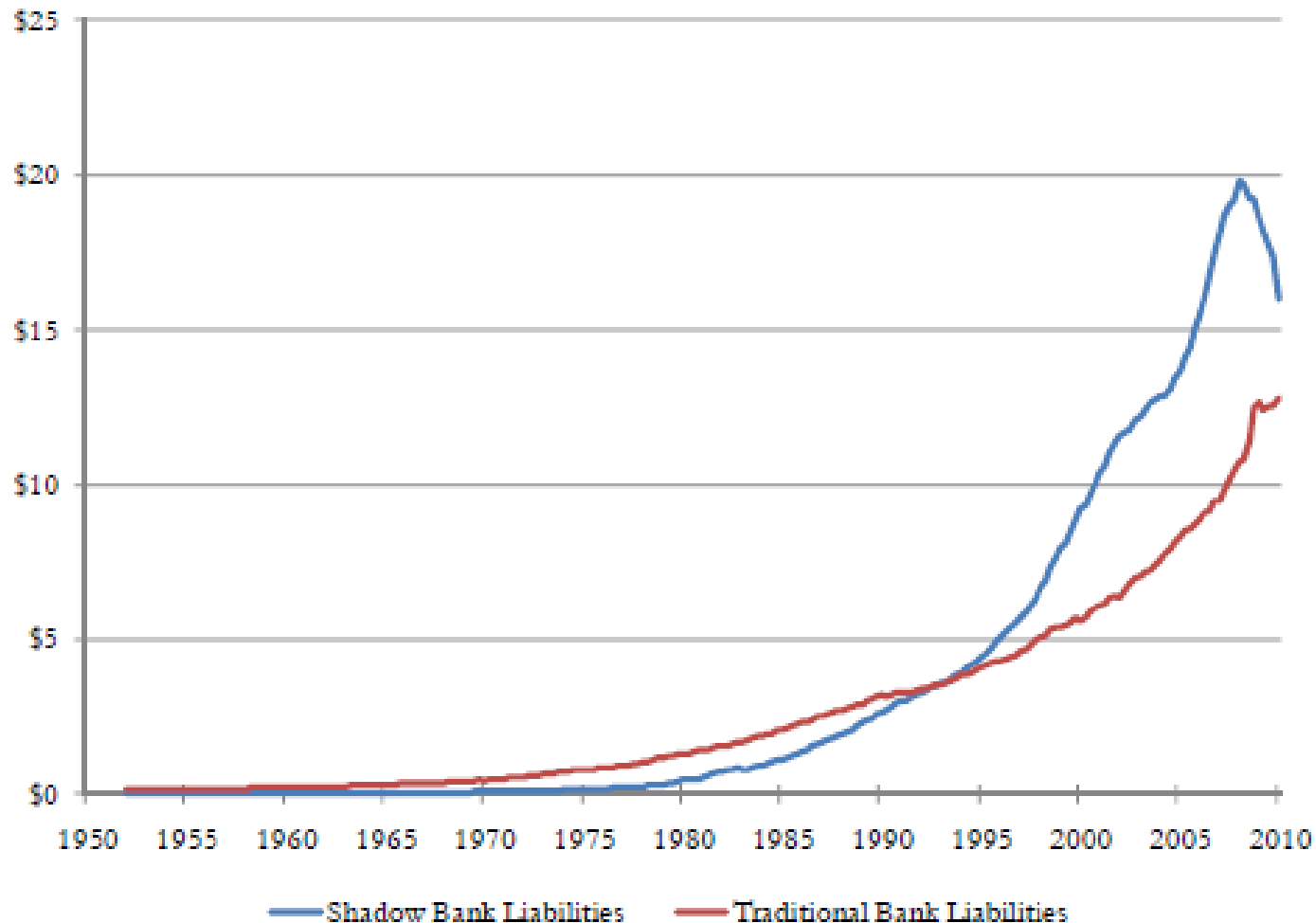


Source: Philippon (2008).

Source: Haldane, *et al.* (2010)

And the shadow banking system casts a long shadow indeed (actually, even worse than it seems...)

Figure 1: Shadow Bank Liabilities vs. Traditional Bank Liabilities, \$ trillion[†]

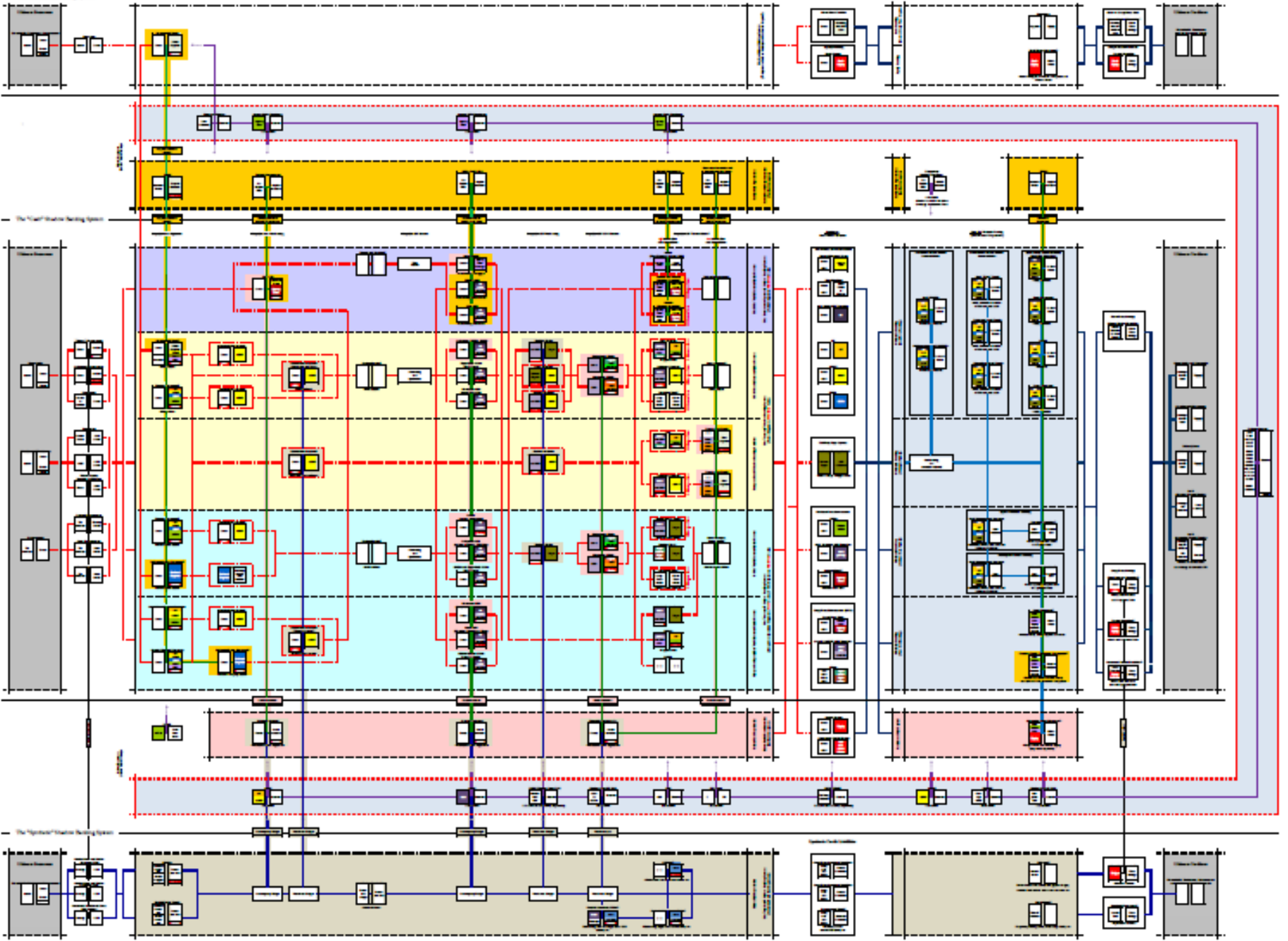


Source: Pozsar *et al.*, 'Shadow banking', FRBNY Staff Report no. 458, July 2010

The Shadow Banking System

Copyright © 2009 and revised by John Taylor www.johntaylor.com
The Federal Reserve Bank of New York, December, 2009

The Shadow Banking System





Banks back to business as usual – size and structure

- Banking sector already highly concentrated pre-crisis, now even more so – they have *even more monopolistic and political power*, and ‘consolidation’ hasn’t finished
- Banks not just TBTF (or TBTR), they are simply ***too big*** – to regulate, even to manage – huge barriers to entry
- ‘Volcker rule’ not Glass-Steagall and hard to implement
- Could ***break them up*** – but only European Commission might do a little of that, US DoJ and UK Competition Commission not interested, nor finance ministries – and EU likes universal banking
- No legislative authority in D-F, UK Banking Commission unlikely to recommend breakup, government not keen



Yet problems are obvious

- In US, banks have been making money off the yield curve, but many small banks failing, housing market still a threat
- In Europe, still haven't dealt properly with bad assets, stress tests weren't serious, many banks still dependent on ECB, particular problems in some countries (Landesbanken, cajas)
- In all countries, still a tax bias for debt over equity
- And bank corporate governance is weak, big bonuses return

Business as usual



“The dreams of avarice are coming back.”

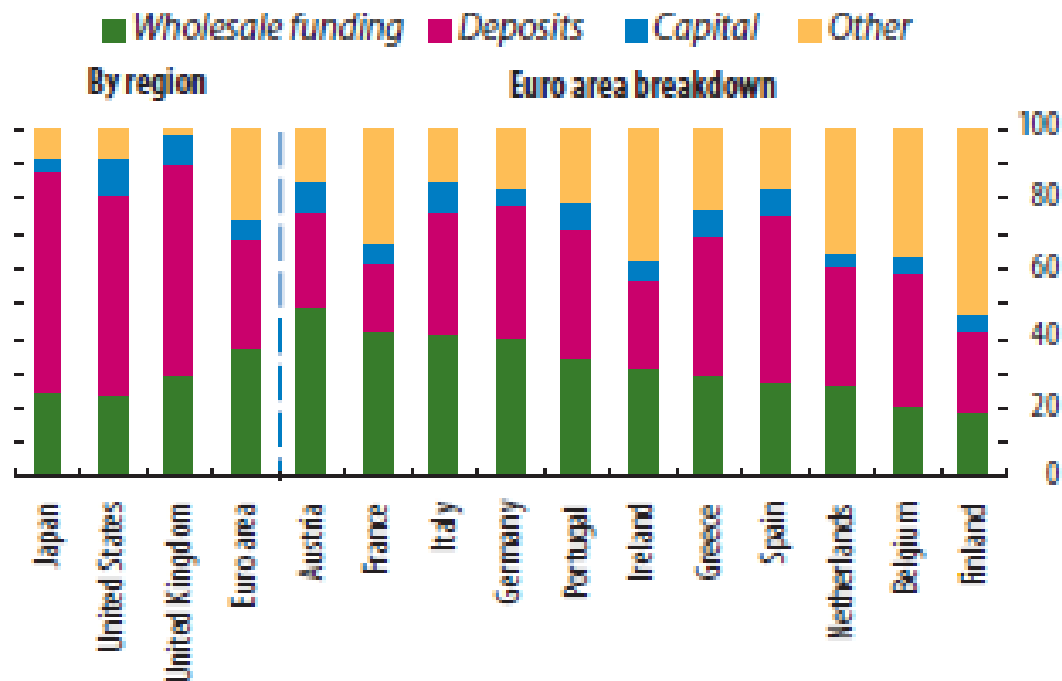


But Basel is busy: microprudential

- Basel III focus on *capital ratios* – but still nowhere near high enough, excessive transition periods, banks happy...
- No surprise: heavy bank lobbying, disagreement among regulators – some think they did brilliantly, and their banks shouldn't be forced to 'pay for others' mistakes' (Canada, France, Australia...) – where is G20?
- Countercyclical: does Basel III have it right? (Repullo *et al.*, *Economic Policy* October 2010, say no)
- Cap on leverage (ratio 3%!)
- Maturity mismatch: there will be a liquidity coverage ratio (from 2015) and possibly a 'net stable funding ratio' (from 2018!) – certainly need something: wholesale funding is still 40% of euro area bank liabilities

Figure 1.19. Reliance on Wholesale Funding

(Percent of total liabilities, as of end-June 2010)



Source: IMF,
*Global Financial
Stability Report*,
October 2010

Sources: Bank of Japan; European Central Bank; Bank of England; and U.S. Federal Reserve.

Note: Wholesale funding includes bonds, short-term securities, interbank financing, and central bank financing. For euro area countries, other funding includes external liabilities, defined as liabilities from outside the euro area. Data for Ireland exclude banks in the International Financial Services Centre. Data for Japanese investment banks as of end-March 2010.



Macroprudential

- Capital conservation buffer – but won't vary countercyclically
- Rather, 'as a bank's capital level moves closer to the minimum requirement, the conservation buffer would impose a constraint on the bank's discretionary distributions' – but the discretion (in implementation) will rest with the supervisors!
- No quantitative tools like max loan-to-value ratios
- No integration of macroprudential with monetary policy
- IMF staff view of micro and macro Basel reforms (N. Sacasa, 26 August): 'second-best workable compromise' [= *fourth-best?*] – so much for G20 brave pledges...



Resolution of SIFIs

- Prevention? Effective risk management is impossible in excessively complex SIFIs
- Special Resolution Regime in UK, D-F gives FDIC authority – but
 - 'Near the top of the list for Rep Spencer Bachus...in line to become chairman of the Financial Services Committee, is to repeal the provision that calls for the government to seize and liquidate large troubled financial firms...[he] has argued that creates the expectation that investors will be bailed out, and contends that existing bankruptcy law should govern failing financial institutions.' (*NYT* 3 November)
 - Contrast IMF (SPN/10/15, 3 October): 'moving this work forward will require political commitment at the highest levels'



Basel working on it...

- ‘...could include combinations of capital surcharges, contingent capital and bail-in debt...’ (Basel Committee Report to G20, October 2010)
- But universal reluctance to make creditors take hit
- And no progress on cross-border issues! Burden-sharing...
- We understand better the nature and sources of systemic risk, but what to do about it? – two years after Lehman and the G20 declaration
‘...many of the structural characteristics that contributed to the build-up of systemic risks are still in place today...[And] much of the information needed remains unavailable to those overseeing financial stability’ [!] (IMF, SPN/10/15, 3 October) – *a very shadowy banking system indeed...*



"Let's never forget that the public's desire for transparency has to be balanced by our need for concealment."



Markets: derivatives are key

- Volcker says 'creation of derivatives has far exceeded any pressing need for hedging', Soros calls for ban on naked CDS
- But financial markets and finance professors argue for 'market completeness' – any innovation is good!
- Commodities and Futures Modernization Act 2000 blocked any regulation of derivatives, a major mistake – there is some reversal in Dodd-Frank, including some separation of derivatives trading from banking



Policy failures

- Very slow move to central counterparties for OTC derivatives (and only for products that can be standardized)
- But ***no requirement for exchange trading*** of these instruments – the opacity and specificity of OTC is just too profitable for the banks to give up (Bolton et al.)
- And regulators must determine what can be standardized...with Rep Bachus watching:
‘[he] said the new derivatives rules, which will require most routine swaps to be traded on exchanges and routed through clearing houses, will redirect as much as \$1 trillion from the U.S. economy.’
- ***No ban on 'naked' CDS*** – although crisis has shown that these are dangerous tools for speculation and market manipulation, rather than benign hedges



Rating agencies

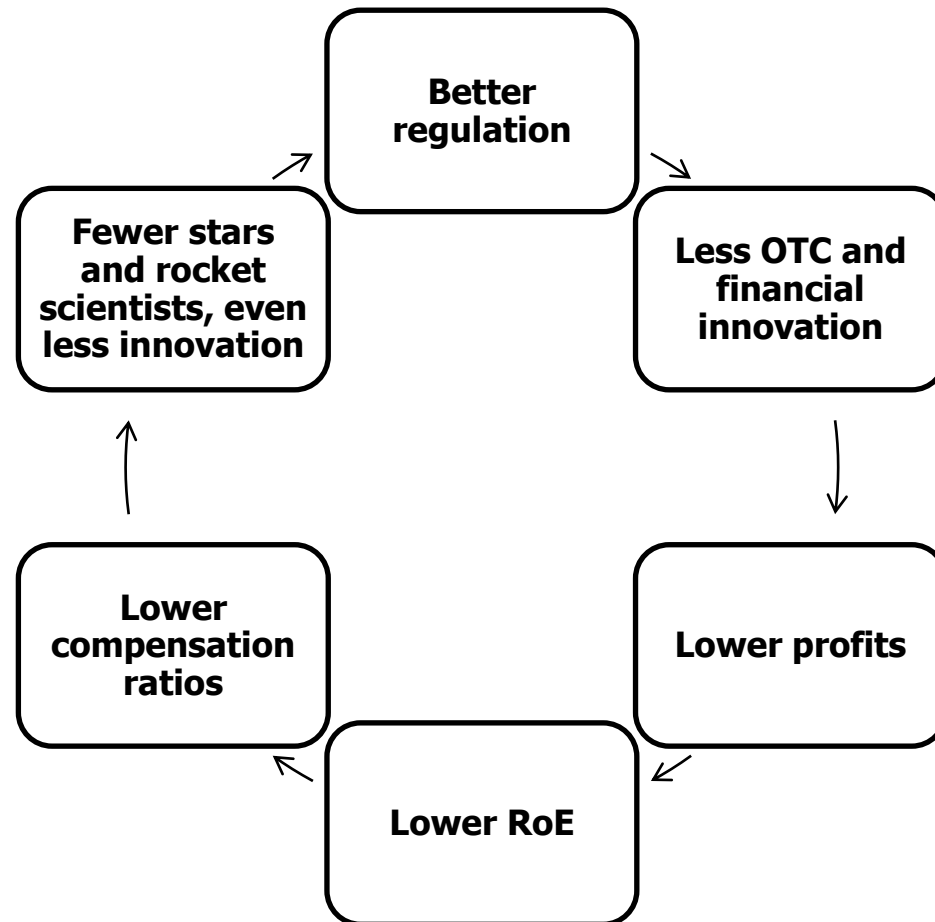
- Will separate rating from 'advisory' services
- 'Monitoring' of agencies and their models – useless
- Unlikely to make much progress in breaking up the oligopoly...
- ...unless authorities ***remove the 'regulatory license'*** – regulators have 'outsourced' their responsibilities for evaluating riskiness of institutional portfolios
- SEC might go a bit in this direction, no sign that UK or Continental Europeans will do, although FSB takes this seriously



Weaknesses going forward are squarely in the scope of G20

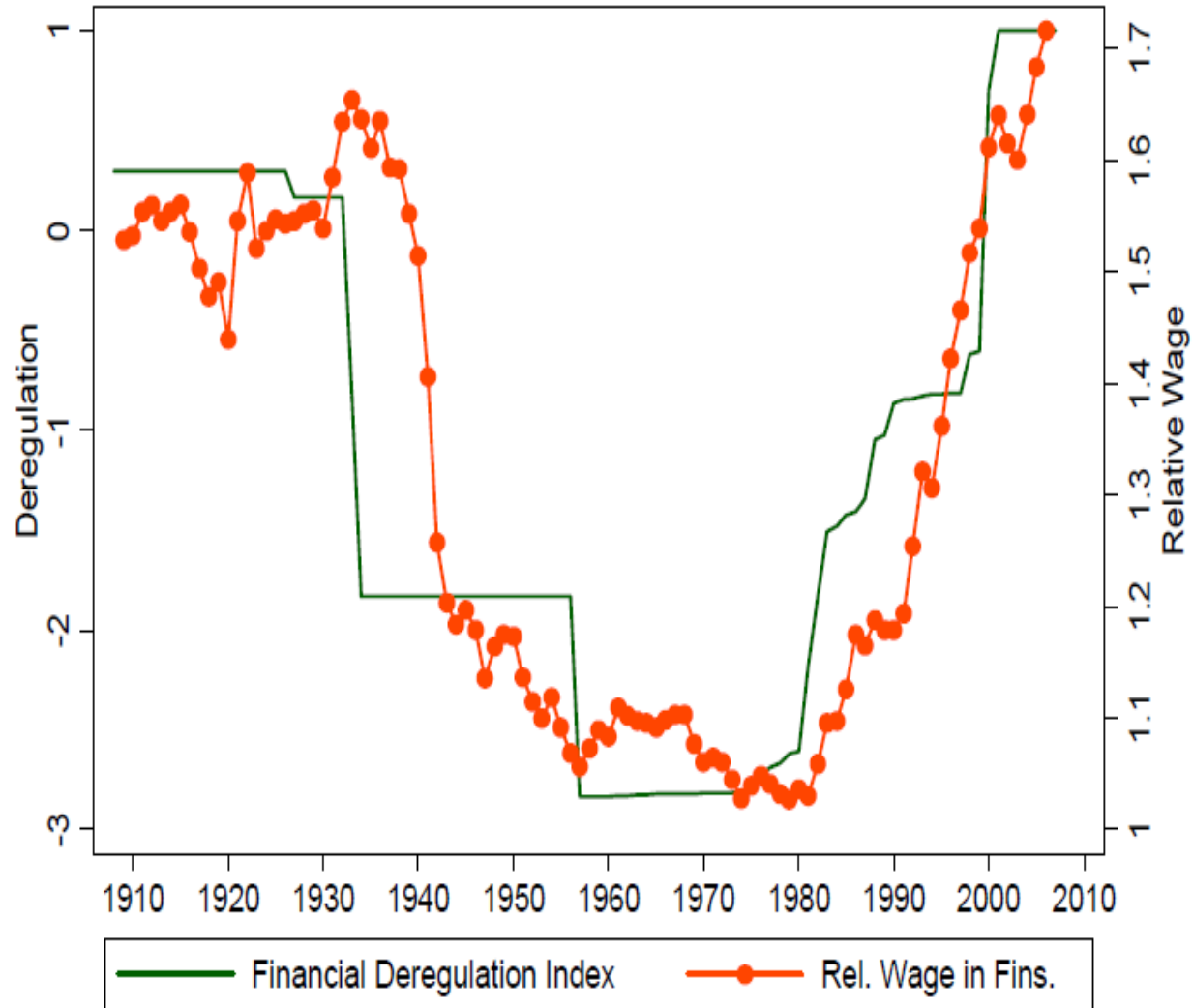
- Governments and national regulators still want to defend 'their' banks (which may in fact be global SIFIs)
- They also want to keep them, while others are conscious of possible gains from regulatory arbitrage
- Many countries want their own global financial centres – and some unlikely places are competing (not just Dubai – what about Chongqing?)
- Implementation of new regulations is vulnerable to lobbying, political constraints, staffing constraints (funding of regulators) – could international pressure help?
- The required coordination and cooperation are the G20's explicit role – but don't expect much from Seoul...

Still, some potential good news – could there be a virtuous circle?



Have we been there before?

Figure 6: Relative Financial Wage and Financial Deregulation



Source:
Philippon
and Reshef,
'Wages and
Human
Capital in the
US Financial
Industry',
CEPR
Discussion
Paper

Notes: Wages are computed from the Industry Accounts of the U.S., from Kuznets (1941), and from Martin (1939). The relative wage is the ratio of Fins to Non Farm Private wages. See the text for the definition of the deregulation index.