Rebuilding the Post-Crisis Financial System

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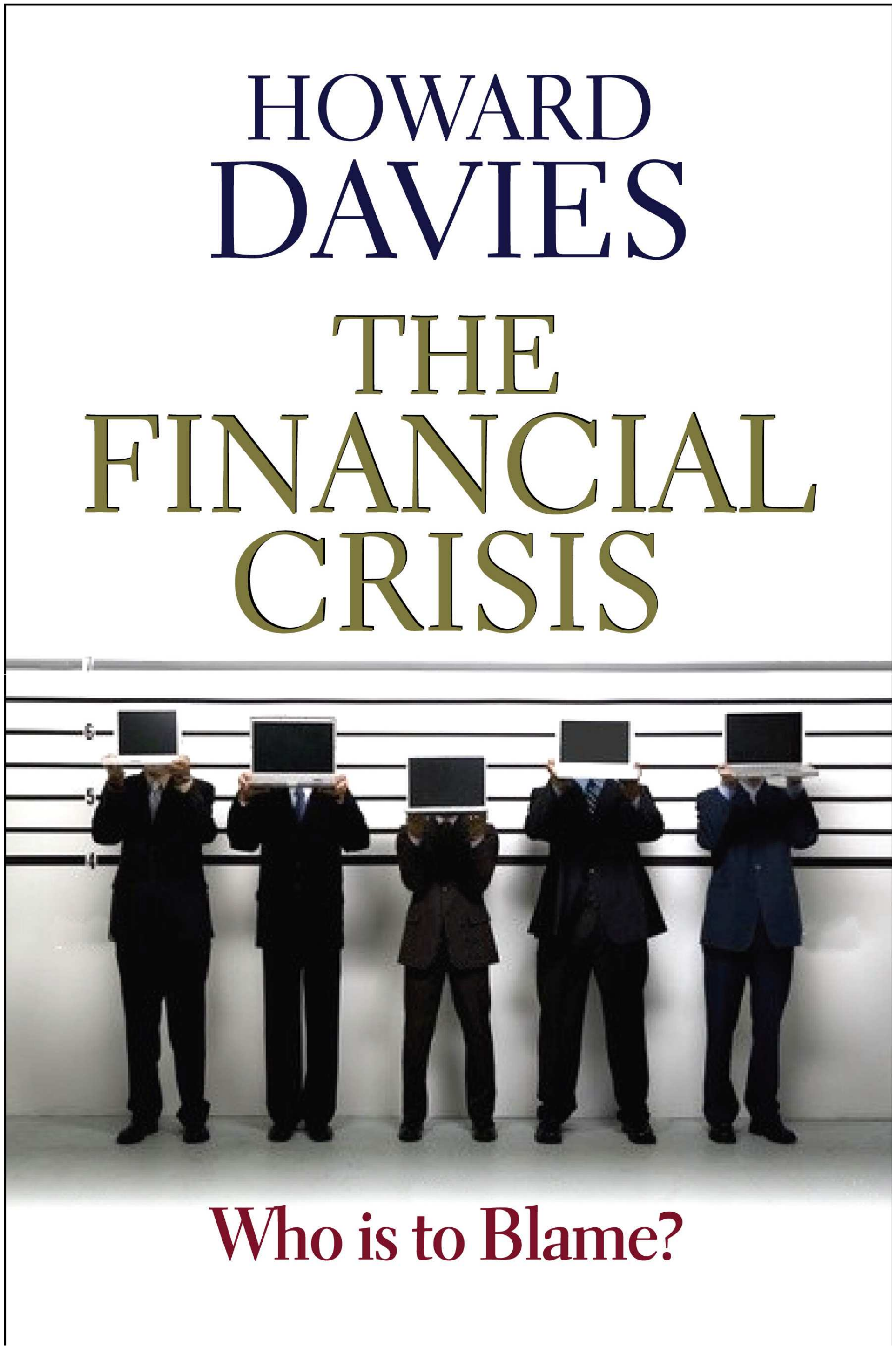
Peking University, 26 July 2010


HOWARD
DAVIES
THE
FINANCIAL
CRISIS
Who is to Blame?

What are the underlying causes?

- global imbalances

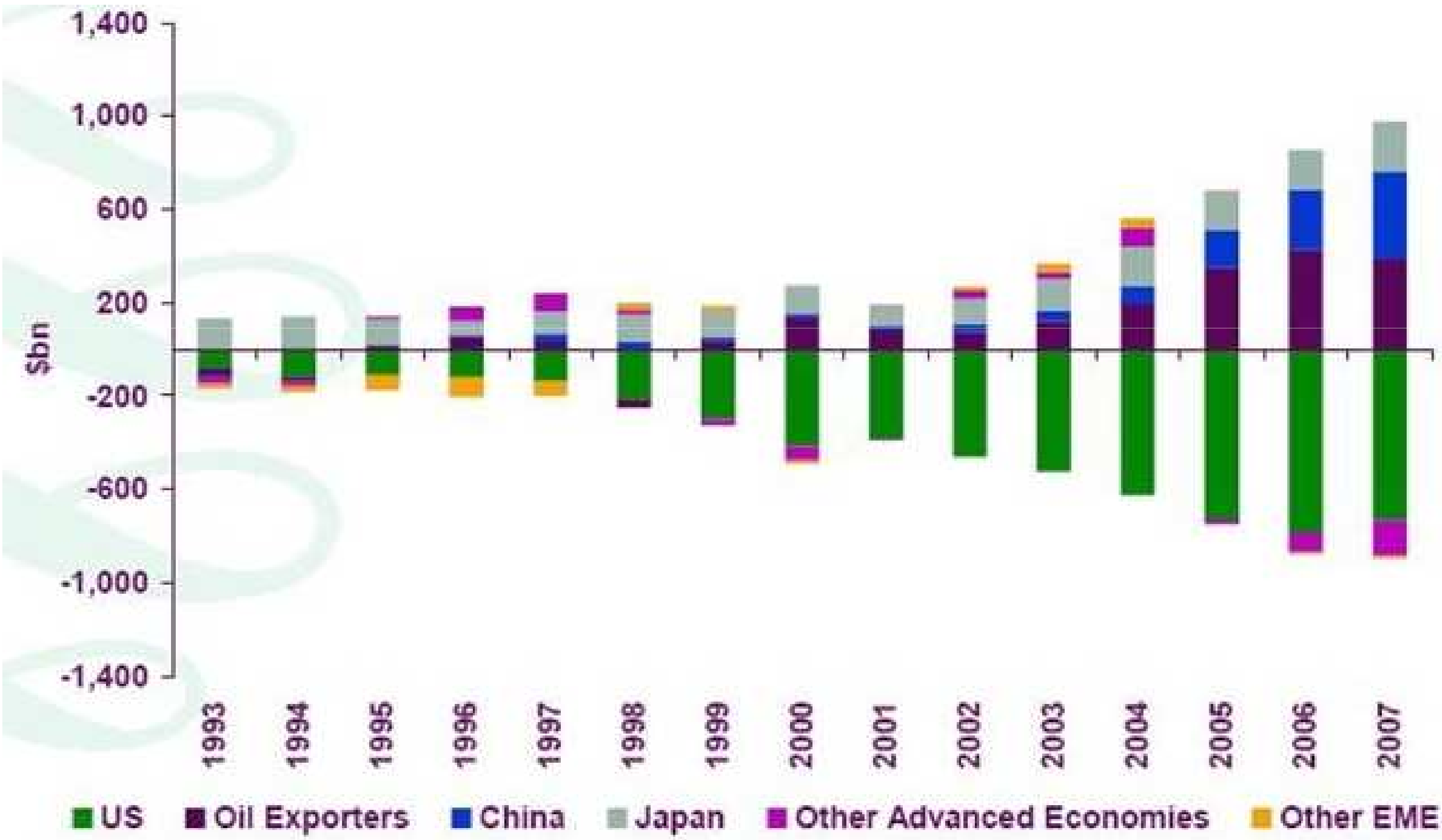
- loose monetary policy, leading to
    - mispricing of risk
    - credit and asset price bubbles

- ‘excess’ leverage, facilitated by procyclical regulation, and regulatory arbitrage

- ‘excess’ unmanaged growth of the financial sector, with complex new instruments, which magnified risks, rather than diversifying them

Global current account imbalances grew rapidly from 2003

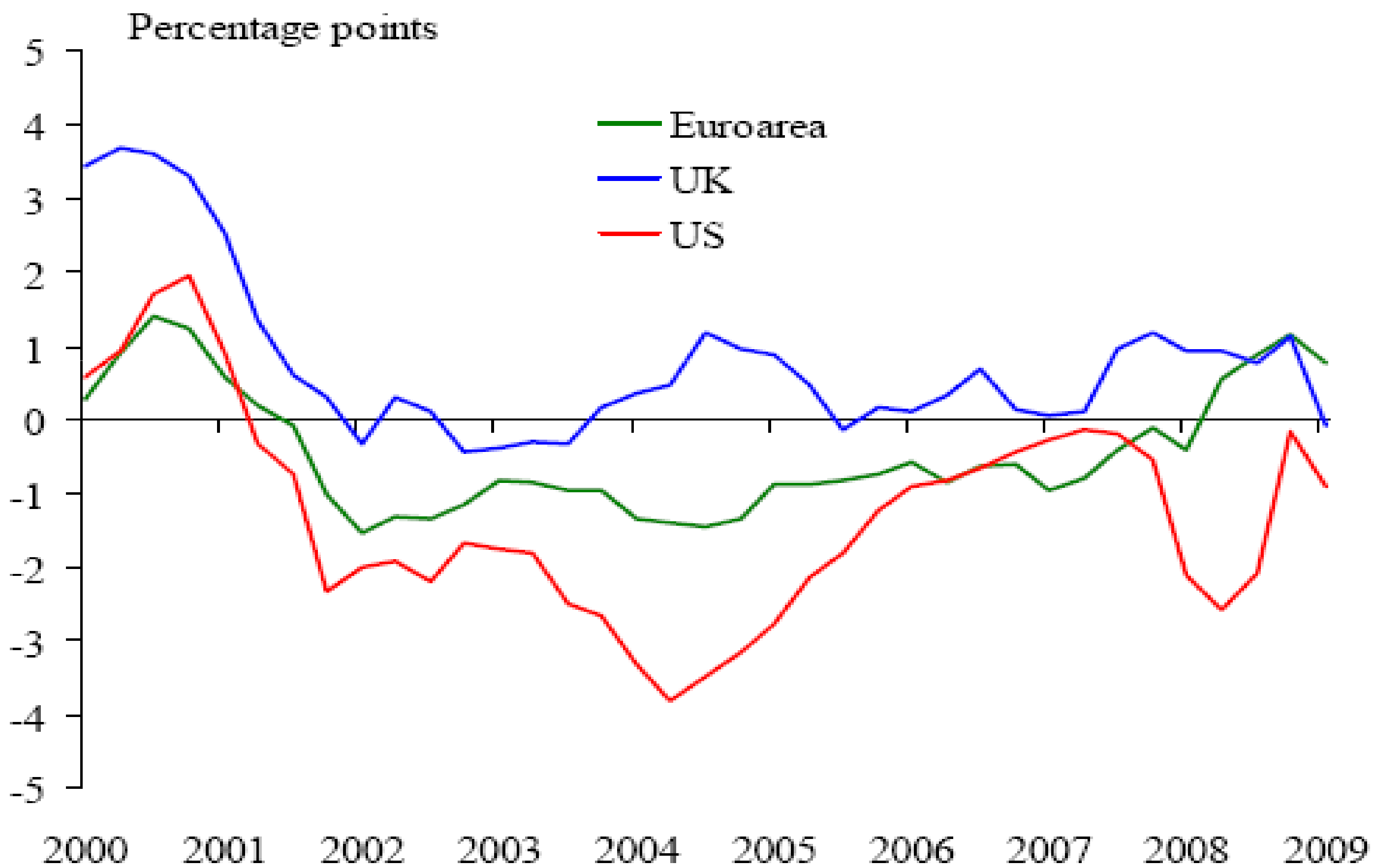
Estimates of account balances for selected countries ($ Billion), 1993-2007



Source: Datastream, FSA Calculations.

Monetary policy was loose, especially in the US

Deviation of policy rates from Taylor rule (%), 2000-2009



Source: Bank of England, Speech of Charles Bean at the Annual Conference of the European Economic Association, 25th Aug 2009.

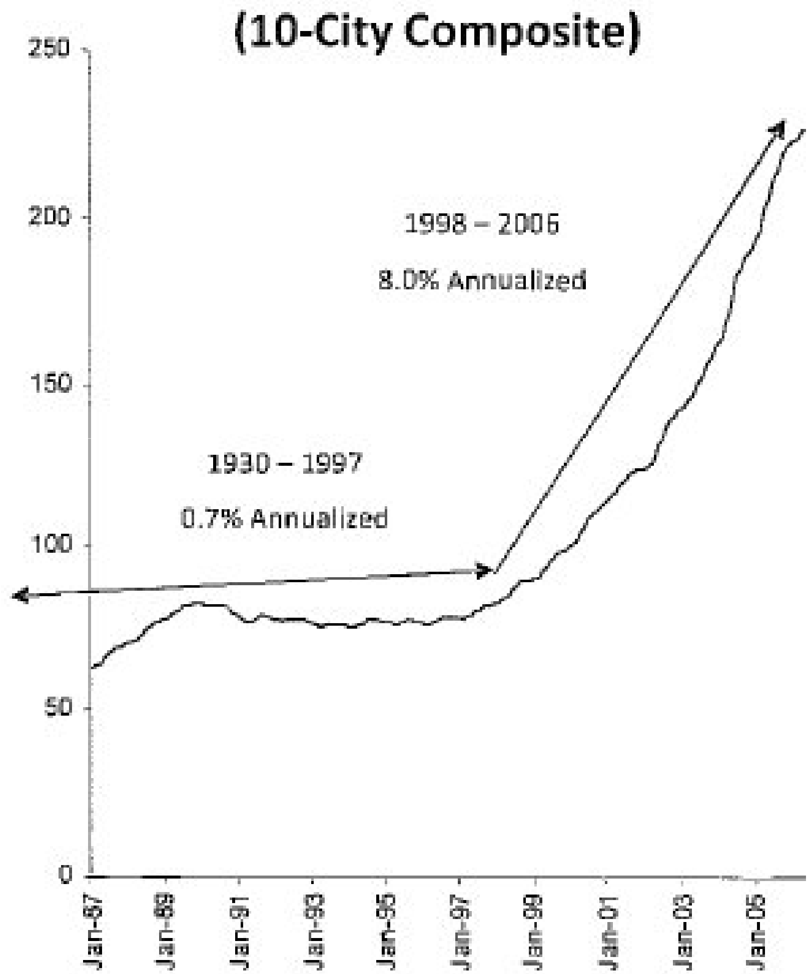
Household debt rose sharply

Household debt (% of GDP), 1987-2007

Source: FSA, ONS, Federal Reserve, Eurodata, Datastream

US house prices doubled in five years

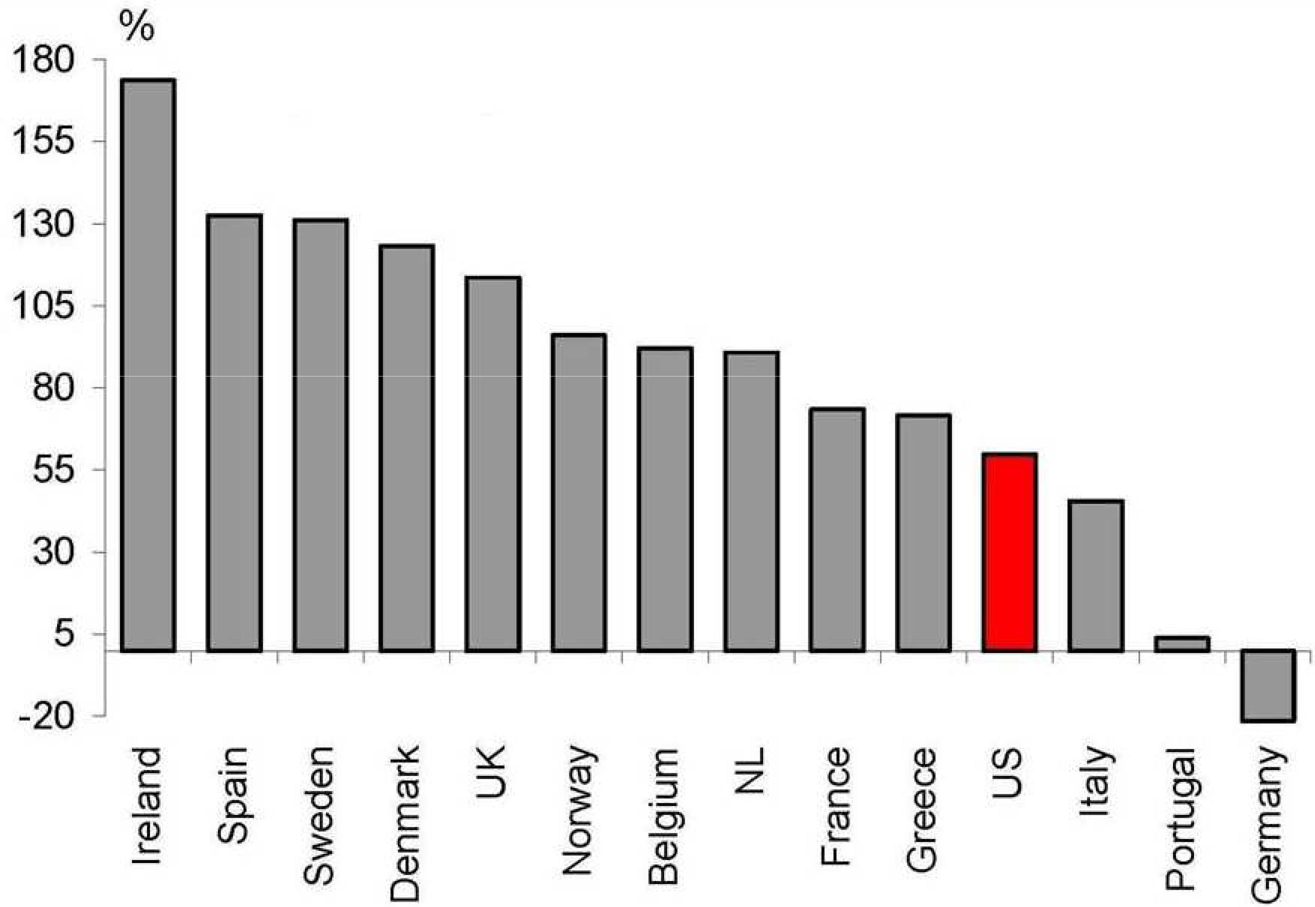
Case-Shiller Home Price Index (2000 Q1 = 100), Jan 1987 - 2005



Source: Silverlake, Case-Shiller Price Index.

House prices rose rapidly in much of Europe also

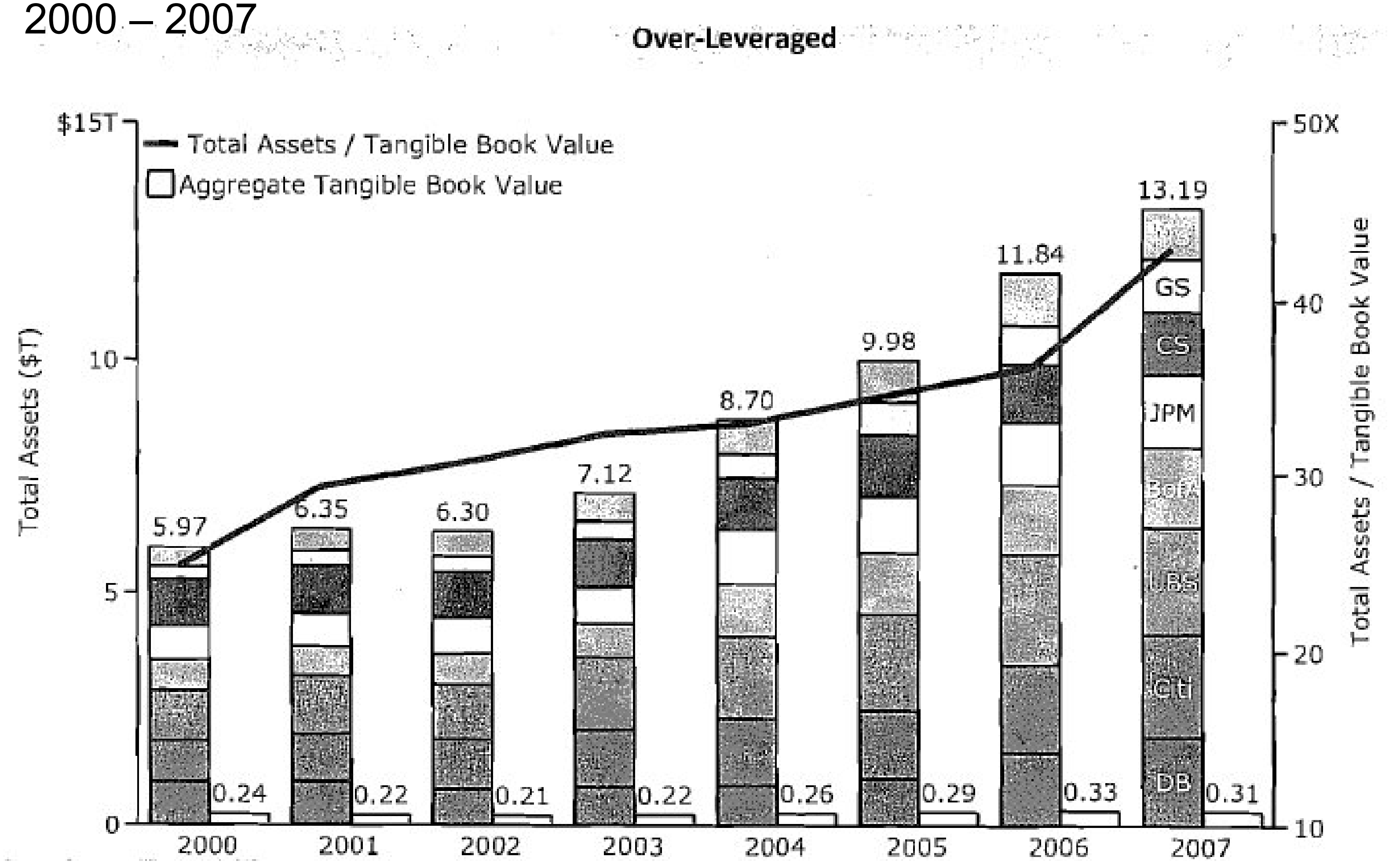
Real house price changes (%), 1996-2006



Source: ECB, National Statistical Offices, IMF, EMF, Italian Ministry of Infrastructure, Morgan Stanley Research.

Bank Balance Sheets expanded

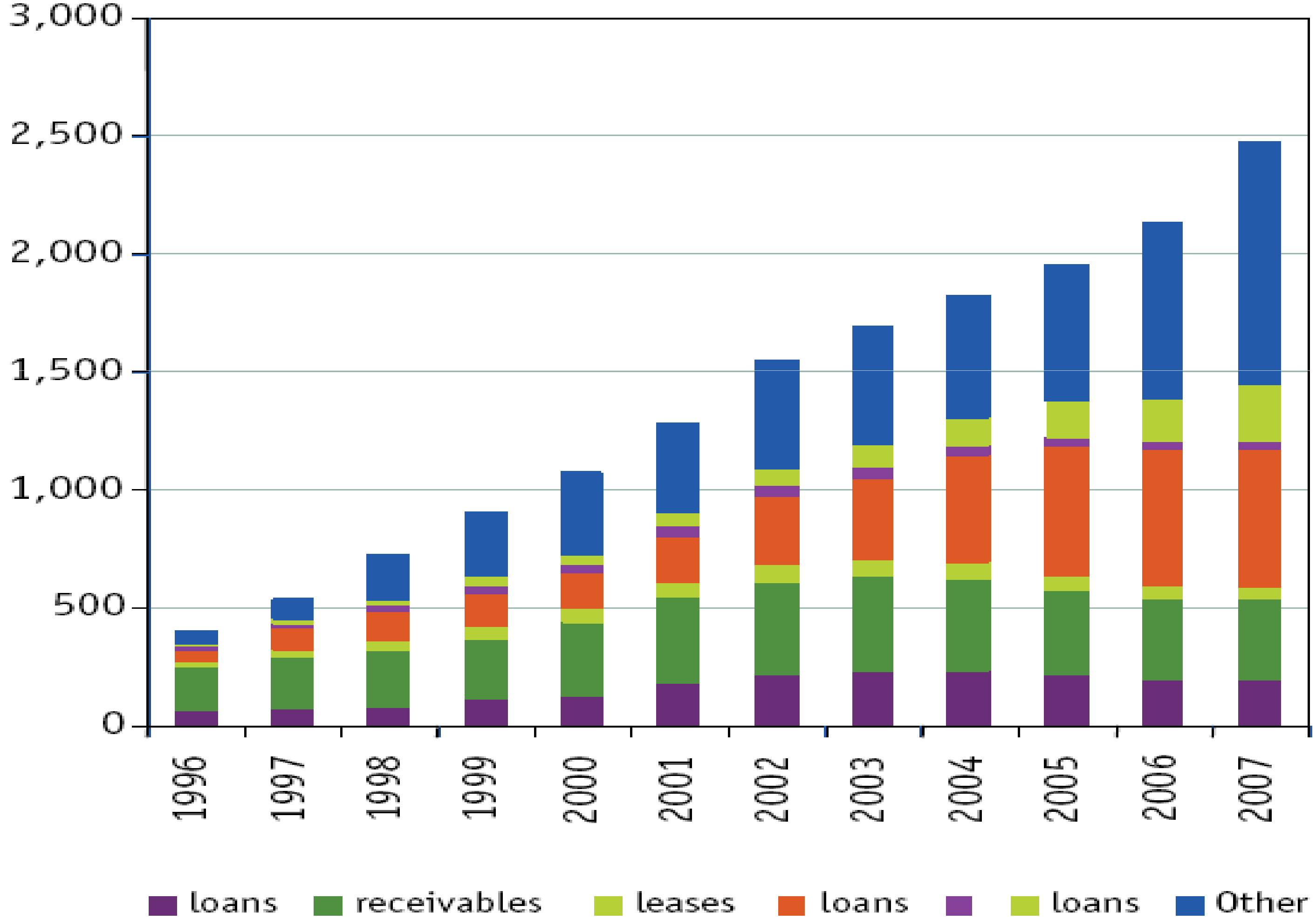
Large-cap banks' aggregate assets rose to 43x tangible book equity, 2000 – 2007



Source: Silverlake, Capital IQ.

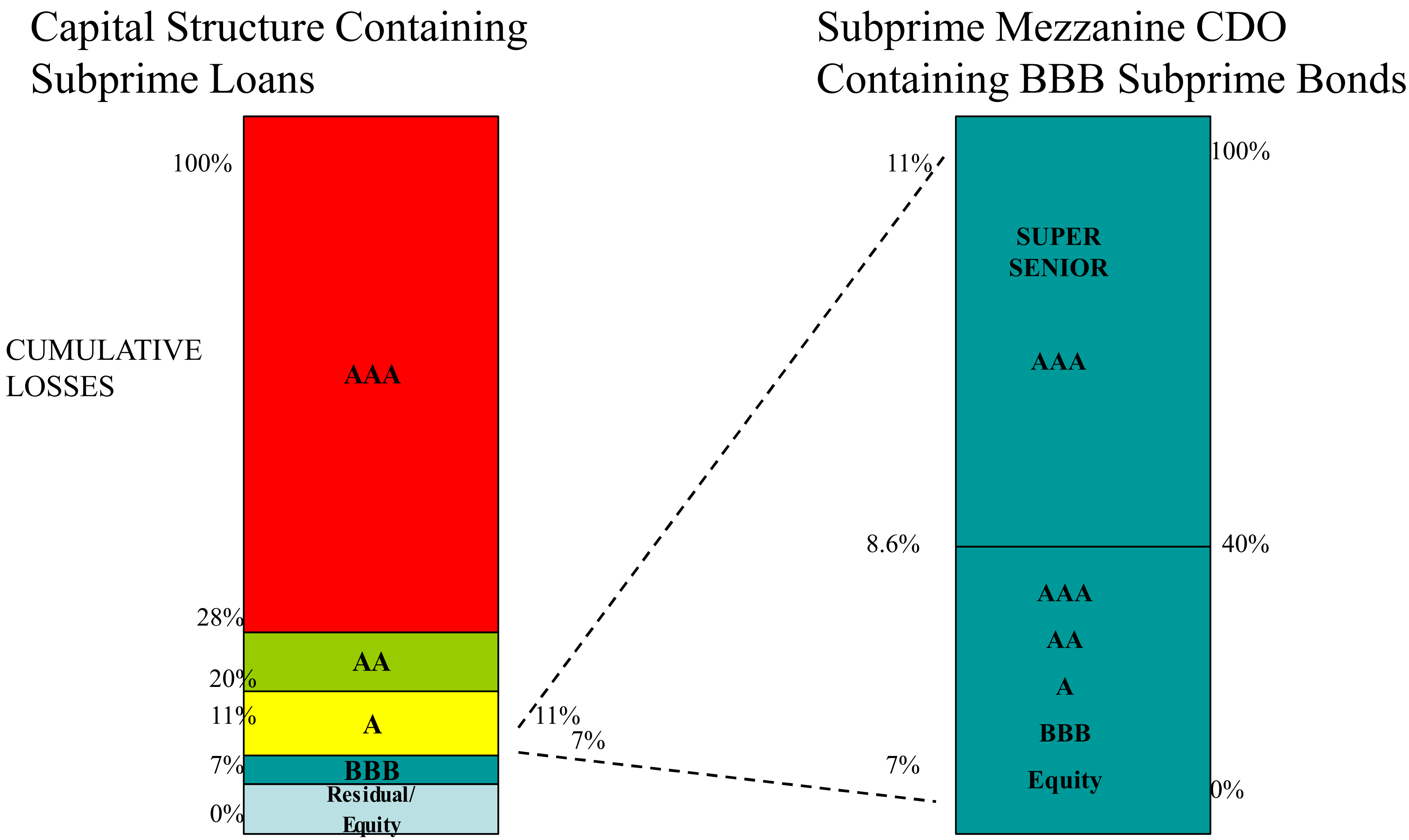
As did the securitised credit market

ABS – volumes outstanding ($ Billion), 1996 - 2007



Source: The Turner Review, March 2009.

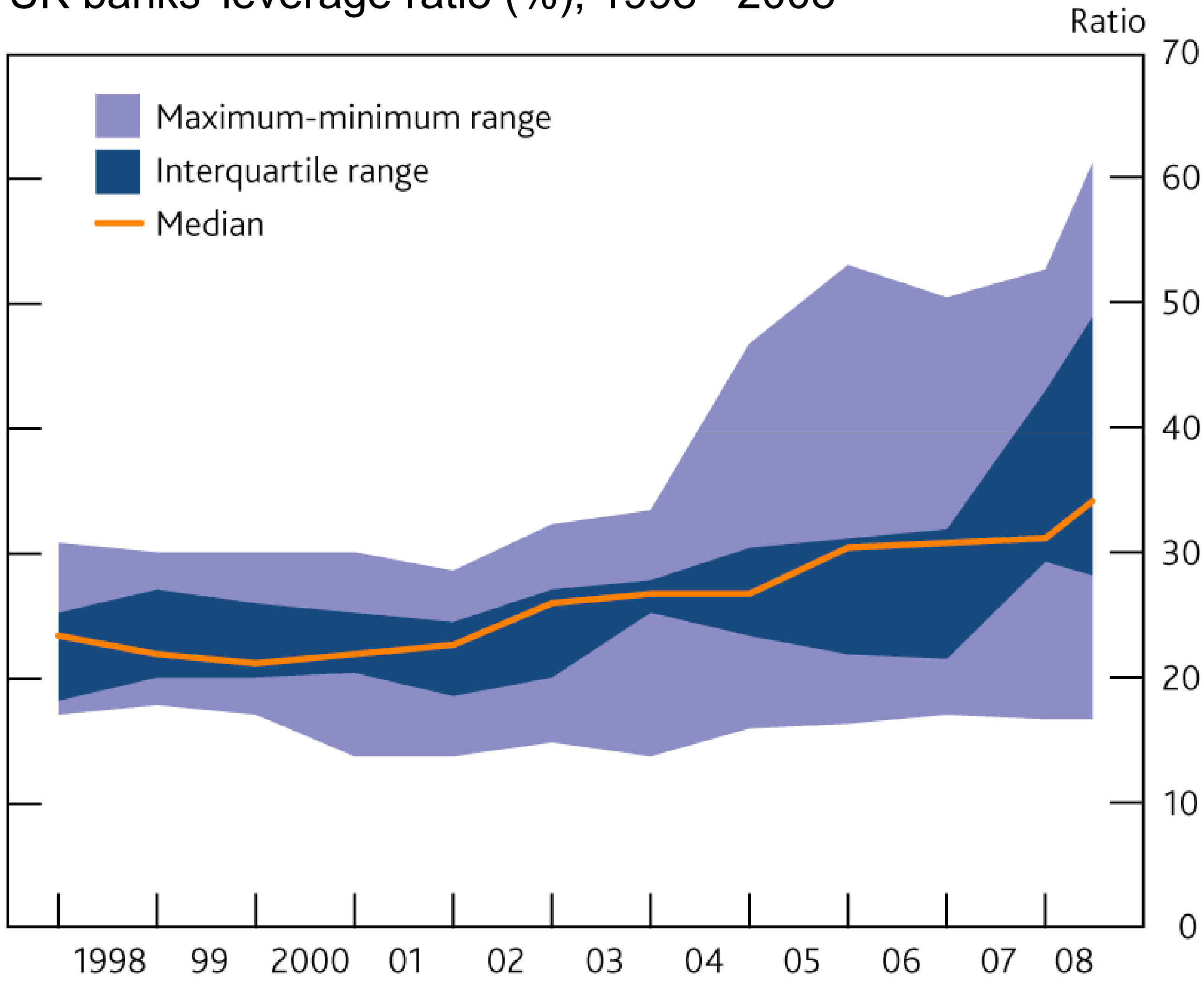
Resecuritisation magnified credit creation



Source: Morgan Stanley.

UK banks leverage grew sharply from 2003 onwards

Major UK banks' leverage ratio (%), 1998 - 2008



Note: Leverage ratio defined as total assets divided by total equity excluding minority interest. Excludes Nationwide due to lack of interim data.

Source: Bank of England, Financial Stability Report, Issue 24, 28 October 2008.

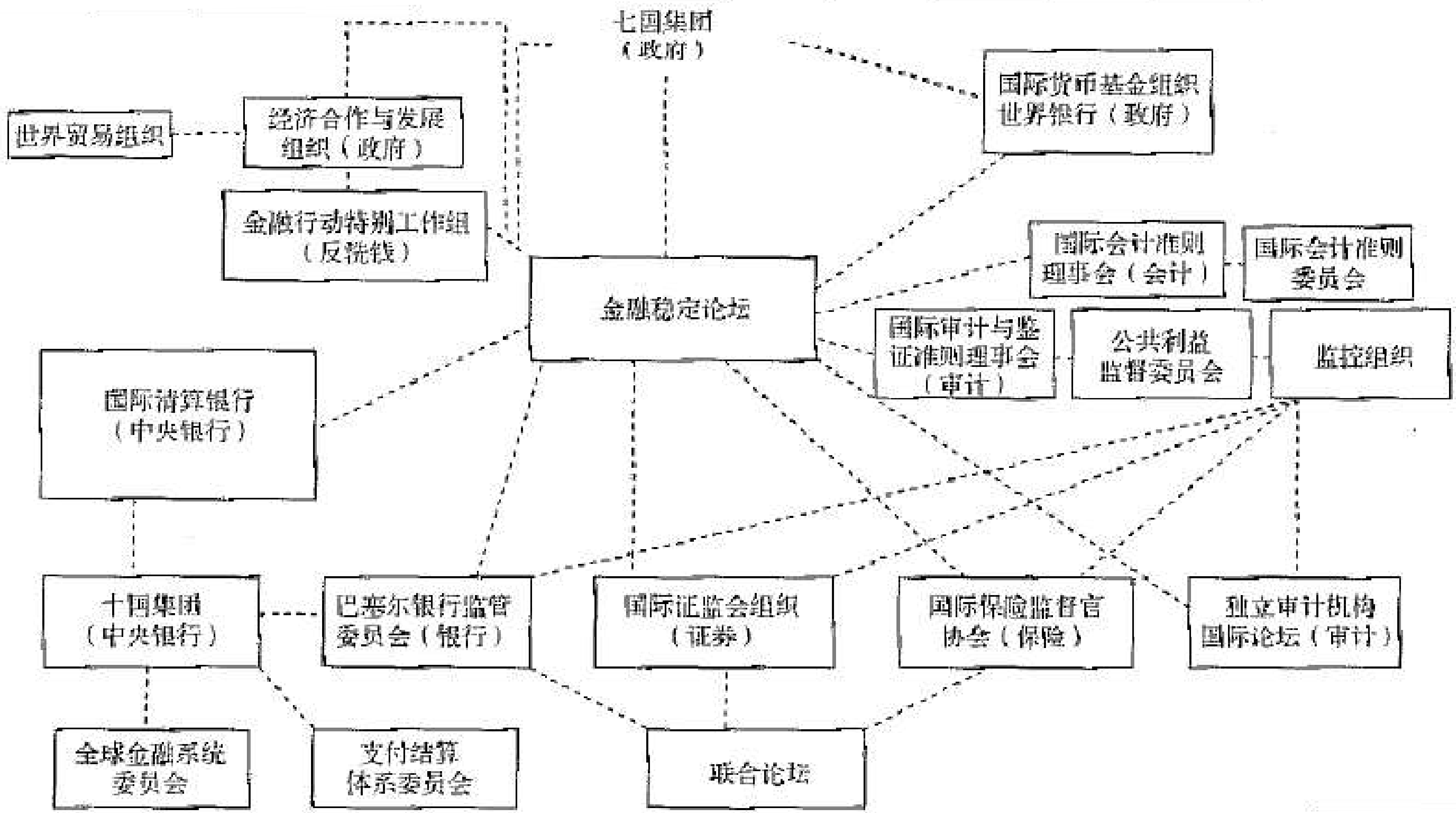
This points to the need for monetary policy to focus more on

- credit growth
- financial intermediation, and
- asset prices

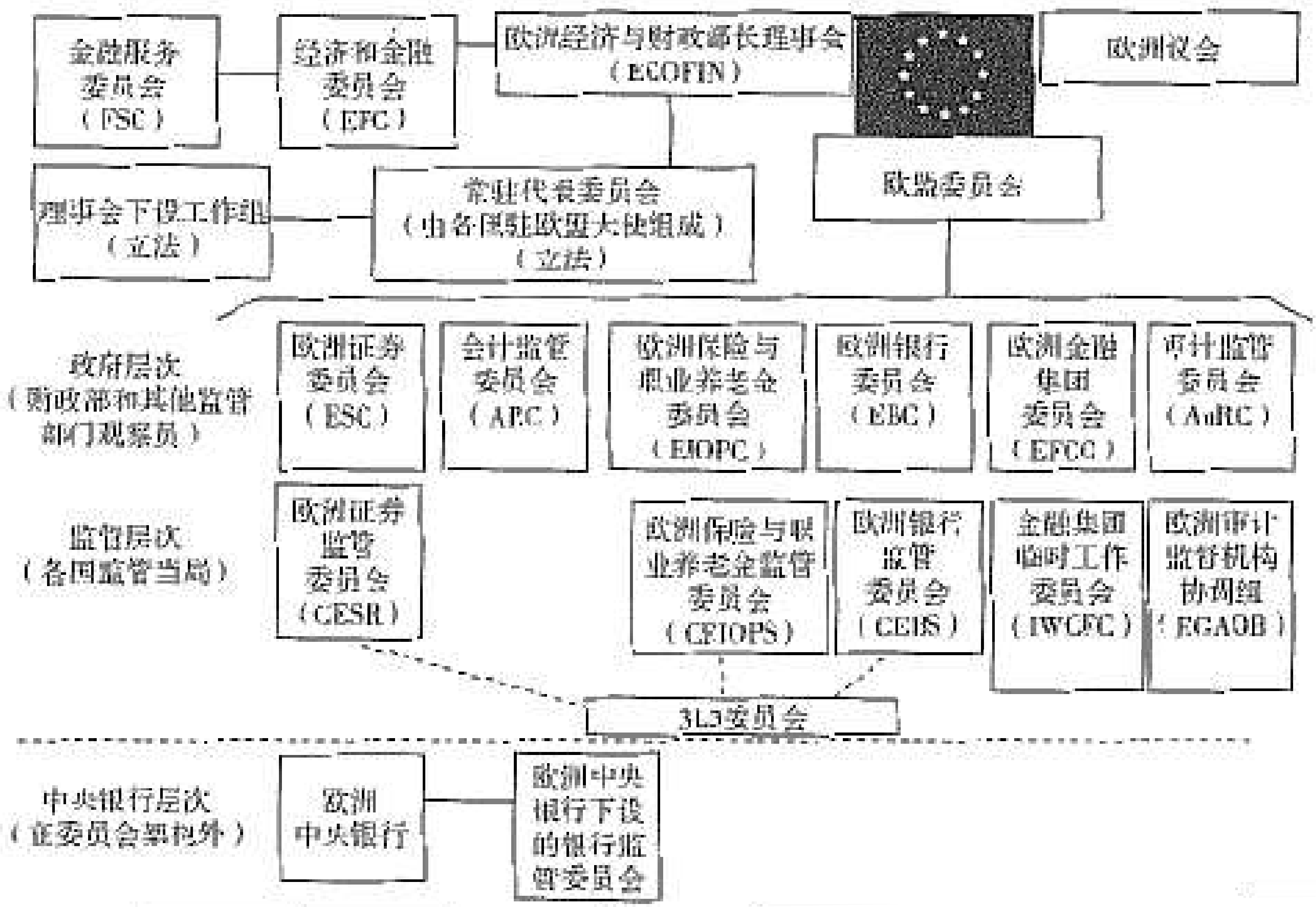
…with a stronger emphasis on offsetting the risk of financial instability

The crisis revealed problems with the existing regulatory architecture

- Complex global structure
- Lacking a central authority to drive co-operation and make changes happen
- US system balkanised and ineffective
- European system – neither truly European nor truly national
- No two national systems the same



Source: H Davies, D Green (2008), Global Financial Regulation (Chinese edition).



Source: H Davies, D Green (2008), Global Financial Regulation (Chinese edition).

Six Problems with the System

1. Complexity
2. Built on the old three-sector model
3. Unrepresentative membership
4. US dominance
5. No single European voice
6. No authority or hierarchy

G20 Summits

"Reshaping the global financial and regulatory system"

- Financial Stability Board with standing committees
- Membership of FSB, Basel etc extended to BRICs and others
- Expanded coverage of regulation to include systemic hedge funds
- Tighter controls on offshore centres
- Tighter regulation of credit rating agencies
- More and better quality capital in the banking system
- Macro-prudential mechanism to respond to asset price bubbles
- Regulatory controls on bank remuneration

And there were a number of specific regulatory failures

US Financial markets regulation was uncoordinated and overlapping

- Promoted regulatory ‘competition’
- Firms became ‘too big to fail’

European Regulation also at fault: complex mix of European and national rules

In the UK, weak FSA regulation of Northern Rock, and the Bank of England too distant from financial markets

US regulation

The charge: The US system is balkanised, over-complex and riddled with inter-agency turf wars. There is no federal insurance regulator. The SEC and CFTC are regularly in dispute. State regulation can cut across federal. No system-wide regulator.

The response: The Dodd-Frank Act merges the OTS with the OCC and gives the Fed system-wide authority. Derivatives on-exchange. Volcker rule bars proprietary trading by banks. But still no insurance regulator or CFTC – SEC merger.

Casino-banking/ Too big to fail

The charge:

The effective abolition of the Glass-Steagall separation between commercial and investment banking in 1999 allowed banks with access to insured deposits, and to the Federal Reserve window, to gamble in highly risky markets, with taxpayers left to pick up the tab.

The response:

In the US, the Volcker rule will prohibit some proprietary trading and investments in hedge funds and private equity firms. BUT other countries, especially in Europe, are unlikely to follow this route (though the UK may). And is it in fact an effective response to the 'too big to fail' issue?

More regulatory failures

Key markets were unregulated

- Non-bank private mortgage industry
- Credit Default Swaps
  - No exchange, central clearing or capital requirements

Insurance industry in the US was lightly regulated

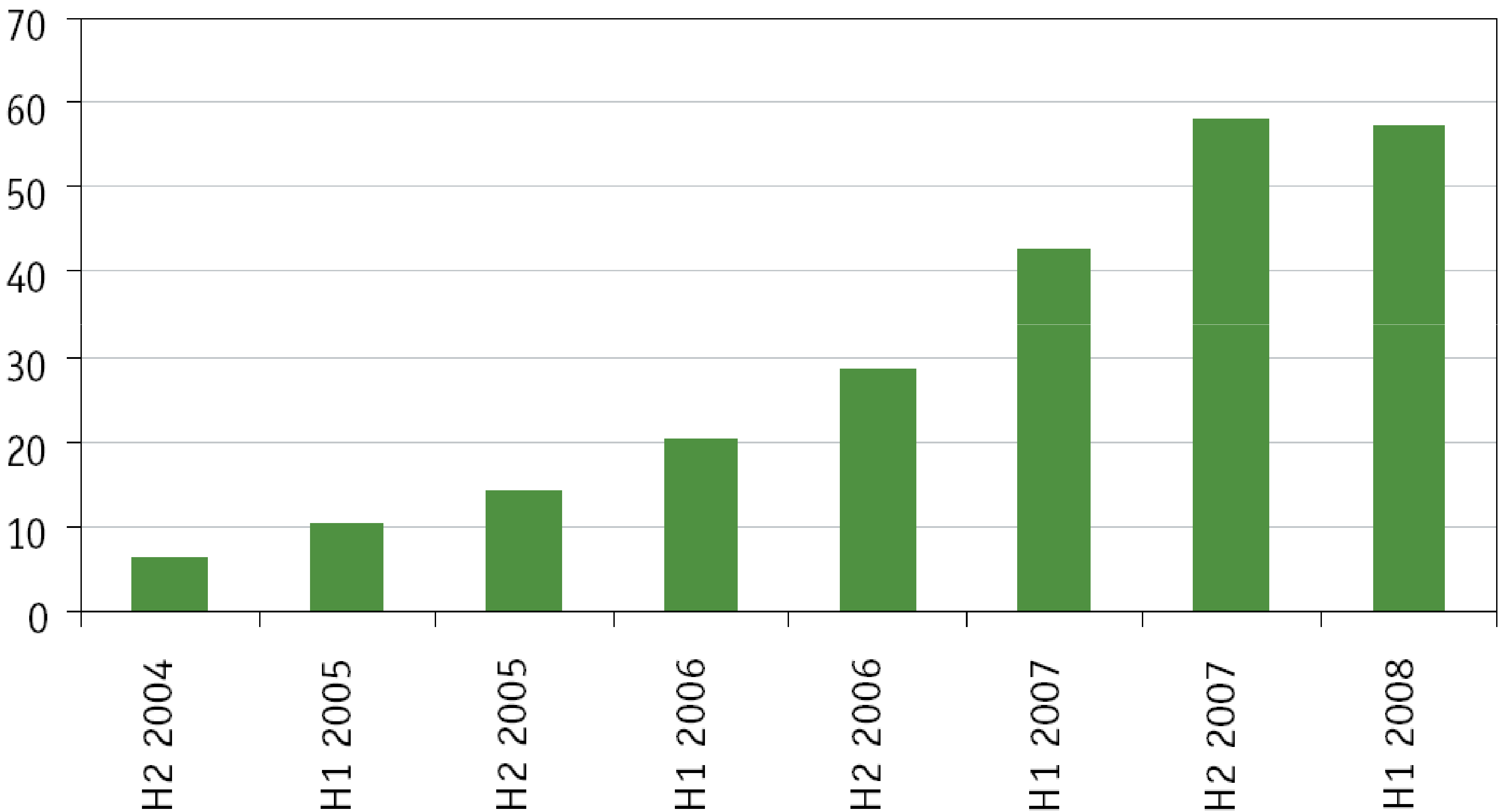
- No federal regulator
- Missed "one-sided" credit insurance & CDS risks taken on by AIG and others

Basel II capital requirements were flawed

- Allowed too much leverage, over-reliance on credit ratings, and didn't encompass liquidity
- Pro-cyclical: as asset prices rose, banks seemed to need less capital

The CDS market exploded in 2006

Credit default swaps, $ Trillion, H2 2004 – H1 2008



Source: The Turner Review, March 2009.

A capital shortage

<u>The charge:</u>

Banks were allowed to operate with too little capital. Leverage grew, and revenues were inadequate to cover losses when asset prices fell.

<u>The response:</u>

‘Basel 3’ will triple capital in the trading book, outlaw ‘soft’ capital, increase capital backing for securitizations and strengthen balance sheets generally. <u>BUT</u> will the reforms damage the system and make credit scarce and too costly?

Procyclicality

<u>The charge:</u> The capital rules tended to accentuate the cycle, allowing banks to hold less capital as asset prices rose, as back-testing revealed low losses and loss given default over previous years.

<u>The response:</u> Macro-prudential requirements – which will allow regulators to tighten capital in anticipation of price bubbles bursting – ‘leaning into the wind’. Stress-testing. <u>BUT</u> how do we know when there is a bubble? Why not use interest rates ?

Measures to reduce procyclicality

Objective	Intervention
Improve risk measurement by banks	Require the use of through-the-cycle or conservative inputs to risk models
Raise awareness of systemic risk	Regularly publish official assessments of vulnerabilities
Reduce procyclicality in financial reporting	Require through-the-cycle valuations
Enhance market discipline	Require disclosure of risk positions, including uncertainties in measuring them
Reduce compensation incentives to take excessive risk	Require longer horizons for risk-adjusted employee performance measurement; back-load bonuses

The Changing Lexicon of Regulation

Light touch	➡	Intrusive
Competitiveness	➡	A price worth paying
It's OK unless we say it's not	➡	It's not OK unless we say so
Fit and Proper	➡	Competent

Failures in the financial firms themselves may have been even more important

- Poor risk management
  - excessive reliance on Value at Risk Models
  - herding behaviour
  - inadequate hedging
- Flawed capital allocation mechanisms
  - trading strategies under-capitalised
- Incentive structures which reward short-term risk-taking
- Weak corporate governance: boards ignorant of the risks management were taking on

And there is little evidence of change

And, finally, there are major problems with Economics – and efficient markets

Much of the past 30 years of macroeconomics was "spectacularly useless at best, and positively harmful at worst"

Prof. Paul Krugman, Princeton

"The unfortunate uselessness of most 'state of the art' academic monetary economics"

Prof. Willem Buiter, LSE

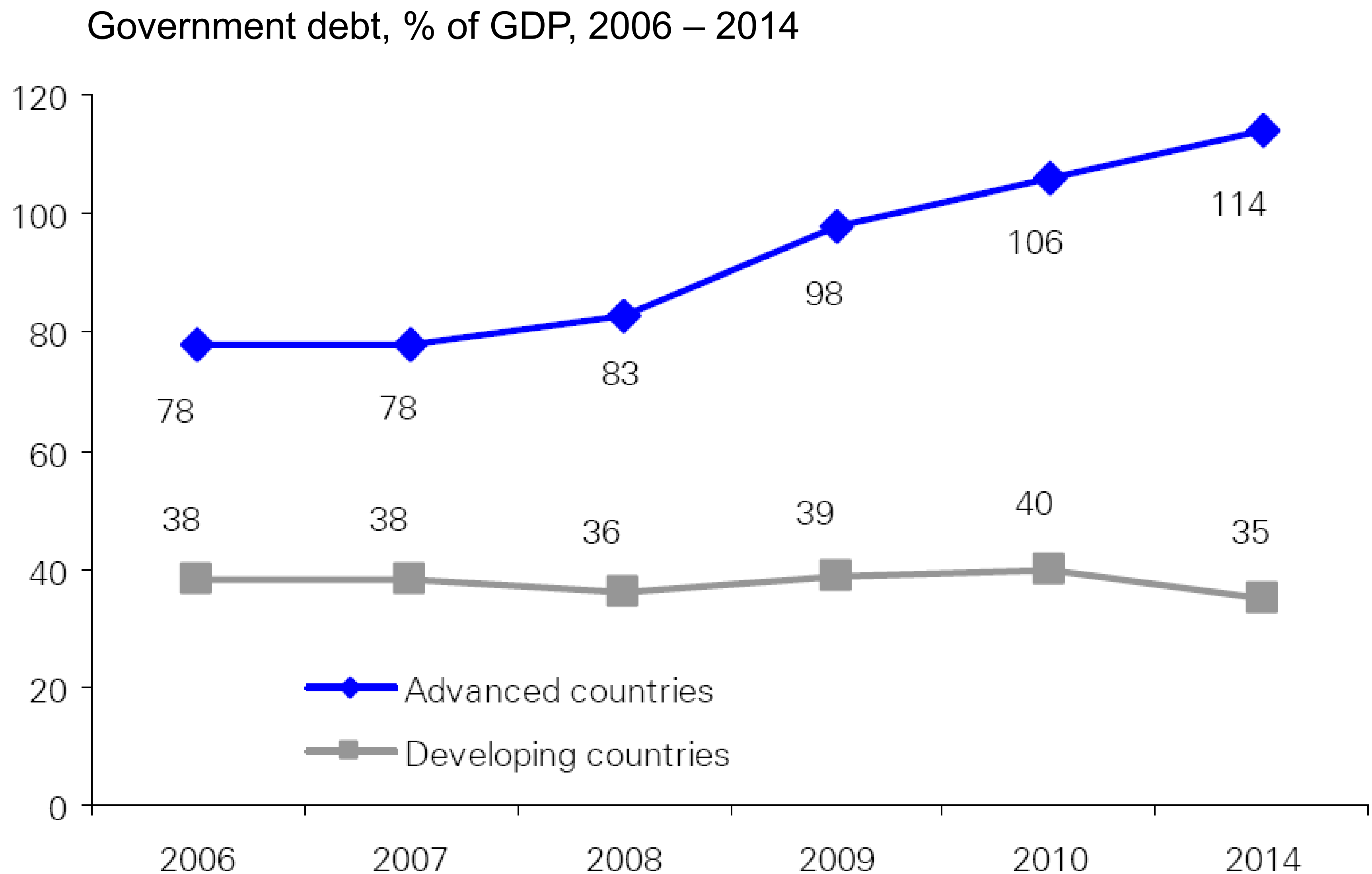
"The modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year"

Alan Greenspan

G20 (5 June)

- ‘the global economy continues to recover faster than expected, though at an uneven pace across countries and regions’
- ‘recent events highlight the importance of sustainable public finances… though countries with serious fiscal challenge need to accelerate the pace of consolidation’
- ‘greater transparency and further strengthening of banks’ balance sheets’

And who's riskier now?



Source: Deutsche Bank, IMF.

Conclusions

- Recovery under way, but very patchy
- World's Economic Centre of Gravity shifting to the East
- Fiscal headwinds will restrain growth in Europe (and possibly the US later)
- Capital increases for banks will come, but the timing is uncertain
- Domestic political considerations are dominating the global regulatory agenda
- Regulatory reforms under way, but not addressing all the problems which emerged

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