Criteria for financial regulation after the current crisis

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The recent financial crisis again is a result of both a) inherent flows in the way financial market operate (e.g.their tendency to boom bust behaviour) and b) insufficient, as well as inappropriate, regulation. The current crisis has been deeper than others due to the growing complexity, size and opaqueness of the financial system, and the fact it has become increasingly internationalized.

There is a need therefore to design new systems of regulation that will make such crises less likely in the future; those should deal with the old unresolved problems of inherent procyclicality of banking as well as financial markets; they should also meet the new challenges of complexity and opaqueness.

We set out some of the key criteria that should guide such design.

1. Regulation has to be comprehensive

As is often the case it has been true in this crisis that the parts of the financial system are not regulated at all, or are regulated too lightly, have generated more problems. Because of regulatory arbitrage, growth of financial activity (and risk) moved to unregulated institutions (like hedge funds) mechanisms (SIVs) or instruments (derivatives). However, though unregulated, those parts of the shadow financial system were de- facto dependent on systemically important banks via provision of credit, guaranteed liquidity lines or other commitments**.**

A clear example where lack of capital requirements led to excessive growth of unregulated mechanisms was that of SIVs (structured investments vehicles). It is very interesting that reportedly Spanish regulatory authorities allowed banks to have SIVs, but imposed the same capital requirements on them as on other assets. As a result, SIVs did not grow in Spain, nor became a major problem as in the US.

The only solution seems to be thus for total and equivalent regulations of all institutions and instruments. This would discourage regulatory arbitrage and help prevent the build up of excessive systemic risk, which is essential for financial stability. The task of defining equivalent regulation on risk weighted assets for all financial institutions, both for solvency and liquidity purposes is not easy. But it is essential.[1]

A key pre-condition is disclosure

2. Reducing asymmetries of information between markets actors and regulators is an essential pre-condition for better regulation.

In many cases, regulators genuinely do not know the extent to which risks are increasing, and how these risk are distribuited. The more complex and large the financial system the greater the opaqueness and the greater the difficulty to obtain information.

One example are complex and totally opaque OTC derivatives, which reach massive levels. Possible solutions would be to attempt to standardize such instruments but above all to channel them (Soros 2008) through clearing house based exchanges .This would have the benefits of appropriate margin requirements on each transactions, as well as many other sdvantages..

It is interesting that an emerging country, Brazil, has been effective in using regulations and other measures to encourage derivatives to move to established exchanges (Dodd and Griffith-Jones, 2008).

Another, somewhat related, need for increased transparency is for hedge funds (HFs); on this, there is growing consensus (including by the HF industry itself)) that improved information on HFs and other HLIs would also be valuable to investors, counterparties as well as regulators. As pointed out in a previous paper (Griffith-Jones et al., 2007), it seems appropriate for hedge funds to report market risk, liquidity risk and credit risk, as the Fisher II working group recommended. It also seems essential that HFs report the level of leverage, and especially the level of long and short positions.

In this context, it is encouraging that the UK FSA in June 2008 has introduced a tough disclosure requirement for anyone “short-selling” a significant amount of stock in a company conducting a rights issue; the requirements are stringent in that they oblige short sellers to disclose such positions if they amount to more than 0.25% of the total shares outstanding.

[1] Though most transactions (and institutions) solvency can be regulated by equivalent capital requirements n risk weighted assets some transactions e.g. derivatives may be to need regulated by equivalent mechanisms ,vía for example sufficient collateral.or margin.

This rule was introduced due to the strong suspicion that hedge funds were short-selling the stock of companies in the middle of rights issue, thus undermining the ability of banks to recapitalize themselves, which is essential for financial stability at present.

It would seem desirable that such disclosure requirements on short and long positions should remain, should be generalized and become the norm internationally

3. Regulation has to be counter-cyclical

It would seem that the most important market failure in financial markets, through the ages, is their pro-cyclicality. Therefore, it is essential that regulation attempts to compensate and curb this (particularly during booms) by pursuing counter-cyclical regulation. It is encouraging that finally there is growing agreement among academics, institutions like the B.I.S., and increasingly regulators, about the need for introducing counter-cyclical elements into regulation.[2] The questions now are not so much about if, but about how and when, counter-cyclical regulation is introduced.

As regards banks, Goodhart and Persaud (2008) have presented a specific proposal relating capital requirements for banks to recent growth of total banks' assets. This is very important in that it provides a clear and simple proposal for introducing counter-cyclicality into regulation of banks. If such a rule is introduced, it is important that it is done in ways that regulators cannot loosen them easily, to avoid them becoming "captured" by the over-enthusiasm that characterises booms.

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

Second, is the best way to introduce counter-cyclicality through modifying capital adequacy requirements through time ? Would not the alternative of increasing provisioning against future losses – as done in Spain and Portugal

2 Indeed, current Basle II arrangements accentuate pro-cyclicality (see, for example, Griffith-Jones and Persaud, 2008).

– be a good option, as argued by Ocampo and Chiappe (2003) as well as others? What are the advantages and disadvantages of both approaches?

Finally, there is the crucial issue of timing. It seems key to approve such changes soon, while the appetite for regulatory reform remains high. However, their introduction should be done with a lag, so as to avoid increased capital requirements (especially linked to the weighting given to growth in recent years in the G-P formula, which would be high) putting pressure on currently weak banks.

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 carry trade; there is increasing empirical evidence that such carry trade has very pro-cyclical effects (on over or under shooting) of exchange rates of both developed and developing economies, with negative effects often on the real economy (see Goyson, Stahel and Stulz, 2008, as well as Brunnermeir, Nagel and Peterson, 2008, for developed economies; see also, Dodd and Griffith-Jones, 2008 and 2006, for evidence on Brazil and Chile).

For regulation to be comprehensive, there should be minimum capital requirements for <u>all</u> derivatives dealers and minimum collateral requirements for <u>all</u> derivatives transactions. Collateral requirements for financial transactions function much like capital requirements for banks.

An issue to explore is whether regulation of derivatives' collateral and capital requirements should also have counter-cyclical elements. This would seem desirable. It would imply that when derivatives positions, either long or short, were growing excessively (for example, well beyond historical averages), collateral and capital requirements could be increased. An issue to explore is whether this should be done for all derivatives (a far greater task, but consistent with our principle of comprehensiveness) or for derivatives that regulators think can generate systemic risk (shorting of banks' shares) or policy-makers believe can have negative macro-economic effects (carry trade leading to over or under shooting of exchange rates); the latter more manageable approach may unfortunately allow growth of derivatives that can have negative externalities, of which financial regulators and economic authorities are unaware at the time.

<u>4. Regulation needs to be as tightly co-ordinated internationally as possible.</u>

One of the easiest ways to do regulatory arbitrage is to move activities to other less regulated countries, especially offshore centres. This is particularly, though not only, true for OTC derivatives and hedge funds.

The international community has made important and valuable steps in this direction. However, their efforts are clearly insufficient, given the speed and depth of globalisation of private finance, and its' often negative spillovers on innocent bystanders.

The discussion of a global financial regulator needs to be put urgently on the international agenda. In the meantime, efforts at increased co-ordination amongst national regulators requires top priority. It is also urgent that developing country regulators participate fully in key regulatory for a, such as the Basle Committee. Given their growing systemic importance, it is absurd and inefficient if they do not.

5. Compensation of bankers and fund managers needs to be self-regulated or regulated.

As Stiglitz (2008) points out, incentive problems 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 and are one-sided, positive in good times and never negative, even when big losses occur (Roubini, 2008). Such asymmetries seem even stronger in institutions such as hedge funds, where managers fees rise very sharply if profits are very high, but fall mildly with poor performance, encouraging excessive risk-taking and leverage (Kambhu et al, 2008 and Rajan, 2005).

There could be easy solutions to this problem, including providing only a fixed basic salary on a monthly basis, and accumulating bonuses in an escrow account; these could be cashed only after a full cycle of economic activity has taken place. The incentives would change towards making medium or long term profits.

There are of course some technical issues on how this could best be implemented. These could be quite easily overcome. However, the key problem will be political, to overcome the resistance of bankers and fund managers. Given the magnitude of the current crisis, its' damaging effects on the real economy – especially in major developed countries – this may be the best of times to move forward. The self regulatory route (by the industry itself) could be tried, but I am sceptical it would bring meaningful results; action by regulators seems essential. In the long term, financial institutions and the financial system will actually benefit from a change in compensation schemes. It is the problems of externalities, collective action and principal agency that may inhibit them from reaching a better outcome from their collective perspective. Regulators therefore need to do it for them