# PROPOSALS FOR REGULATORY REFORM

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## I Introduction

It is useful to put crises and responses to it into a historical context. Firstly, is it 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 fairly closed, and there were practically no financial crises. Since the 1970's, and especially during the 1980's and 1990's, there was massive de-regulation, both at national and international level. Since the 1980's, there have been very frequent and very deep financial crises, both in the developing and developed world.

Though crises have complex causes, it seems evident that liberalization of financial markets, especially if not accompanied by appropriate regulation, seems to almost always lead to costly and damaging crises. This implies that financial crises are not inevitable, but 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 an urgent one because the political window of opportunity is a narrow one and can close quickly. This was, for example, an important lesson learned in the wake of the East Asian crises. Even though there was such a major debate about reforming the international financial architecture, including regulation – during and after the crises – in practice very little progress was actually made once the crises was contained, especially in the developed economics (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 bail-outs and costly public recapitalizations of many financial institutions in those countries, that are potentially very costly to their taxpayers. The crisis threatens to lead to an unacceptably serious recession in developed countries and globally. As a consequence, political appetite for more and better regulation is significant. Indeed, steps are beginning to be taken to improve regulation.

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. On the positive side, governments should encourage the financial sector to create financial innovations and instruments that support growth and development in a sustainable way. Governments should – and this is very important – also use regulation to avoid systemic risk being generated, thus preventing future crises, that can be so negative for the real economy.

The principles on which financial regulation needs to be built are, to an important extent, based on the causes of this and previous crises. The first relates to the inherent flaws in the way that banking and capital markets operate; in particular, the main market failure of those markets is their boom-bust pattern, linked – as market participants themselves describe it – to cycles of greed and fear. To help overcome these pro-cyclical patterns of behaviour, a first principle of regulation needs to be that of counter-cyclicality.

The second major cause of crises is – as briefly mentioned above – rapid liberalization within and across countries, accompanied by insufficient, incomplete and inappropriate financial regulation. Indeed, the excesses of financial liberalization and the major mistakes of regulation, as well as its incompleteness, imply a massive policy failure.

## Principles of regulation

To overcome the failures – both of markets and of policy – that have been major factors contributing to the crisis, two key principles of regulation need to be followed: one is that of introducing counter-cyclicality at the heart of regulation, the second is the need for regulation to be comprehensive, so that the domain of regulation coincides with the domain of the market.

a) Comprehensiveness

We will start first with the principle of comprehensiveness.

Financial systems – both nationally and internationally – have undergone very large changes. Regulation has clearly not kept up.

In the United States, and also in other developed countries like the UK, there had been a massive shift of savings from banks to capital markets. As pointed out in d'Arista and Griffith-Jones (2008), only 25% of the US financial systems' assets belonged to commercial banks in 2007. However, commercial banks were the only part of the financial system that were regulated for capital requirements and even that regulation was

partial as off-balance sheet instruments, such as Structured Investment Vehicles, were practically unregulated. Investment banks were very lightly regulated. Other financial actors, like hedge funds, were not at all regulated. Neither were powerful rating agencies ,nor were many mortgage lenders. For some of the financial instruments, like Over-the-Counter (OTC) derivatives that grew the most in the last decade to astronomical levels, there was no transparency and even less regulation. Off-shore centers are subject to no or extremely light regulation.

A massive “shadow financial system” was allowed to emerge, which has no or very little transparency or regulation. Indeed, regulatory arbitrage – the wish to avoid regulations – often drove, or at least strongly encouraged, the growth of financial activity and of risk taking. Indeed, many of the problems that caused the financial crisis arose mainly in institutions (e.g. mortgage lenders) or instruments (e.g. credit default swaps) that were not regulated. This is similar to many previous developing country financial crises, where also the most liberalized and unregulated parts of the financial system were major causes of crises.

In capital markets, there was practically no formal regulation. Private actors, such as insurance companies, pretended they were able 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 essentially became bankrupt during the crisis. This was because they did not have sufficient capital and reserves to fulfil credit swap insurance contracts that had a massive amount of systemic risk. Indeed, no entity – except the governments – was capable of fulfilling credibly such a contract once the crisis spread. Thus, the government not only became the lender of last resort, but also the insurer of last resort, because 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 coincides with the domain of the market; if not, regulatory arbitrage will be inevitable. Another reason – illustrated by recent events, when bail-outs and rescues have been massive – is that there is a need to have comprehensive regulation to avoid moral hazard.

A pre-condition for effective comprehensive regulation is comprehensive transparency. Thus, Over-the-Counter derivatives should all be brought on the exchanges (even if this implies certain micro-economic costs). Off-balance sheets instruments, like Structured Investment Vehicles, should be brought into balance sheets, and on-site inspection of banks and other financial institutions should be expanded. The fact that, in developed countries, governments own capital in many

financial institutions should facilitate this process.

Comprehensive regulation should relate both to liquidity and solvency. As regards solvency, equivalent regulation of different actors, instruments and activities should aim at uniform limits on leverage, as excessive leverage has been such 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 just protect the solvency of financial institutions, but also encourage them to seek more long term funding.

b) Counter-cyclicality

As pointed out, the most important market failure in financial markets through the ages is their pro-cyclicality. In fact, risk is mainly generated in the booms, even though it becomes apparent in the bust. 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 has to follow the principle of counter-cyclicality which implies "leaning against the wind." This needs to happen through simple rules which cannot be easily changed by regulators so they will not become "captured" by the general over-enthusiasm that characterizes booms and relax regulatory standards.

In fact, under Basle II, bank regulation does exactly the opposite. Particularly in the advanced approach, Basle II calculates required capital based on the banks own models; this perversely incorporates the inherent pro-cyclicality of bank lending into bank regulation, thus accentuating boom-bust patterns.

i) Counter-cyclical regulation of provisions and/or capital

Counter-cyclical bank regulation can be easily introduced, either through banks' provisions or through their capital. Introducing counter-cyclical bank provisions has already been done for some time in Spain and Portugal showing that it is feasible. The Spanish system requires higher provisions when credit grows more than the historical average, 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. Introducing counter-cyclical provisions in Spain has been facilitated by the fact that the design of accounting rules is under the authority of the Central Bank of Spain. This helps overcome the issue that accountants in other countries do not

readily accept the concept of “latent” or expected losses, on which the Spanish system is based, preferring to focus on actual losses, the latter information being 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 and systemic bank stability.

An alternative approach for counter-cyclical bank regulation is through capital. Here, Goodhart and Persaud (2008) have presented a specific proposal: increasing Basle II capital requirements by a ratio linked to recent growth of total banks’ assets. This provides a clear and simple rule for introducing counter-cyclicality into regulation of banks. Another virtue of this proposal is that it could be fairly easily implemented, in that it builds on Basle II. Finally, it 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 macro-economic variables, such as inflation and the long-run economic growth rate. It would measure actual growth of bank assets as a weighted average of annual growth (with higher weights for recent growth).

If such a rule is introduced, it is important that it is simple and done in ways that regulators cannot loosen them easily, to avoid them becoming “captured” by the general over-enthusiasm that characterises booms.

Two issues arise. Should the focus just be on increase in total bank 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). However, most systemic bank failures have also been preceded by excessive growth of total bank assets.

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 and accentuating the credit crunch. Indeed, leverage had to be reduced, but this needs to be done gradually.

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.

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.

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.

ii) Regulating compensation of bankers

Another, complementary, way to discourage counter-cyclicality is to regulate 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 and 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. Nevertheless, systemic risk increases, as is recognized even by the Institute of International Finance (that represents major banks).

There is another negative effect of short term bonuses, less often highlighted. In good times, a large part of profits is paid out as bonuses; by being taken out of the banks it is therefore not used to increase their capital. When a crisis comes, bail-outs occur usually to help re-capitalize the banks, which are ultimately paid by the tax-payers. It can be argued that taxpayers are paying ex-post for excessive bonuses.

A political point can be made in that high bonuses and high remunerations contribute to great wealth concentrating 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 also may increase the risk that their regulators become captured.

There could be a simple solution to this problem. Bankers and fund managers could receive a fixed salary. Bonuses could either be abolished (a more radical solution) or they could be accumulated into an escrow account; in the latter 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.

Individual firms or the financial industry 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, outside regulation of compensation schemes may be the best way forward, even from the perspective of the stability of individual financial institutions. It would be particularly beneficial for systemic financial and macro-economic stability.

**Institutional Arrangements**

In terms of new institutional arrangements, for regulation, we need to discuss necessary changes at the national and international level.

Part of a new regulatory structure at the national level should be a Financial Products Safety Commission, the FPSC. (Stiglitz, 2008). This FPSC Commission would assess the benefits and risks of particular products and determine their suitability in general, and for particular users In this sense it would have strong parallels with the US Commission that evaluates risks and benefits of new medicines. There is a clear rationale for this also in financial markets.

Financial markets have innovated, but often these innovations have been damaging for individuals. for the financial institutions and for the whole economy.  Clearly, the financial sector has not done a good job at analyzing the consequences of the products that they produce. Defective products can clearly 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 by and invested in by regulated entities. Each product would have to have a stated objective (e.g. in what ways was it helping manage and mitigate risk; what was the risk profile for

whom the product was intended). Its risk characteristics would be identified, using conservative models which paid due attention to the failures that characterize financial markets. The Financial Products Safety commission would evaluate whether products provided significant risk mitigation benefits of the kind purported by the product. There would be a presumption that there "is no free lunch," i.e. that higher returns could only be obtained 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.

The Financial Products Safety Commission would establish transparency standards that all those dealing with regulated financial entities would have to satisfy (including hedge funds) It would have the power to ban certain products from the balance sheets of regulated entities. The Financial Products Safety Commission would also look at the pricing of these products.

As discussed in some detail above, the regulatory system needs to be comprehensive; otherwise funds will flow through the least regulated part. That is why there seems to be a need, within individual countries, for a financial markets stability commission, having oversight of the entire financial system and providing 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 Markets Stability Commission (FMSC) would assess over-all risks, looking at the functioning of the entire financial system and how it would respond to various kinds of shocks; in contrast, the Financial Products Safety Commission (discussed above)) would look at individual products and judge their appropriateness for particular classes of purchasers.

Such a Financial Market Stability Commission should have identified 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) should report to the FMSC. The oversight over the entire system that the Financial Market Stability Commission would have would help avoid regulatory arbitrage.

At the international level, there is also the need for designing an institutional structure that is consistent with the fact that capital and banking markets have very large parts that operate at a global level. For the domain of the market to be consistent with the domain of the regulator, and thus to avoid regulatory arbitrage between countries and

financial centres, it seems very desirable that there is a global financial regulator. This global financial regulator would design standards to be applied by all countries and jurisdictions, including offshore centres. There could remain parts of the financial system, which had no global connections, eg small banks that lend only to farmers in a particular region, that could be still regulated nationally.However, financial institutions, with any international connections, would 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 to achieve consensus for creating new international institutions, it may be desirable to adapt an existing one. It seems the most appropriate would be to adapt the BIS, (the Bank for International Settlements), given its concern with systemic risk in financial markets and the needs for regulating them, the high quality of its analysis, and its close links with Central banks as well as regulatory bodies. Indeed important elements from the Financial Stability Forum, to which the BIS provides a secretariat, should naturally be incorporated into such 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,(subject that is also studied by the BIS). However, the IMF should not become the global regulator, as this institution already has many important functions to fulfil, (which it needs to do more fully than at present), and it has limited expertise on the design of regulatory standards.

An important issue is to ensure that the new global regulator is not just effective and efficient, but also representative. For this reason, it is important that developing countries are adequately represented, to reflect appropriately 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. It is indeed encouraging that the G 20, in their November 15 2008 Declaration , called for an urgent expansion of the Financial Stability Forum to a "broader membership of emerging economies, and other major standard setting bodies should promptly review their membership". This is indeed urgent, as developing countries are not at all represented in these bodies.(which are therefore extremely undemocratic at present). Such an expansion of membership of those bodies, to include key developing and emerging countries, as well as representatives of regions, to allow representation of smaller and poorer countries, is very important. A similar expansion of membership should take place as soon as possible in the BIS, which though having some emerging country members do not have appropriate representation of developing countries, especially in their Board and amongst their staff.

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. It would allow regulatory reforms to be implemented globally, thus avoiding regulatory arbitrage, and helping prevent future crises. The other option to make capital and banking markets less global, by introducing capital controls, seems less likely to occur at present.

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