Limiting Financial Crises: Demands upon the new financial architecture

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Why limit financial crises?

- Before the crash: misallocation of capital (Spain)
- During the crash: possibly very costly measures to save the financial system, in particular the banking system + Spill-over effects: e.g. Central and Eastern Europe which in 2008 was threatened by a flight of capital
- After the financial crisis: possibility of a debt-deflation process, attempts to stop it in certain countries via monetary policies can lead to possible spill-over effects for other countries, e.g. carry trades

How to limit the occurrence and severity of financial crises?

- Increase the resilience of financial institutions and of markets, with which they are connected
- Stop developments which increase the possibility of spill-over effects
- In particular: limit common exposures, limit leverage and credit expansion to not deviate too much upward (in boom) or downward (during busts)

The role of NGOs

- Such regulation means to significantly intervene in the business activities of banks and other financial intermediaries and thus immediately provokes the ire of the industry to be regulated: Concrete lobbying and work on intellectual climate (cycle of regulatory activity!!)
- In that situation, NGOs concerned about the build-up of systemic risk have an important role to play
- **A**genda Setting, **N**egotiation, **I**mplementation, **M**onitoring and **E**nforcement (ANIME)

Lessons from the last financial crisis

Problems revealed

- Blindness of authorities to the financial cycle of boom and busts: relaxation of lending standards, complex new products, opacity and increasing fragility
- Too great reliance on short-term wholesale funding (liquidity risk), increasing the vulnerability of the system
- Banks that are extremely leveraged and too big to fail and that thus have to be saved
- The danger of non-regulated entities engaging in banking business while refinancing in the short-term wholesale market: shadow banking system is prone to bank runs with attending negative spill-over effects

Blindness, really?

- When reviewing the evidence on what regulators knew pre-crisis, we can see that several problems (such as regulatory arbitrage in the internal shadow banking system) were known to regulators (but picture not put together, threats from liquidity risk underestimated)
- Problems of coordination and regulatory competition in a splintered regulatory framework prevented action (1999-2008)
- → to close regulatory loopholes requires swift coordination, which is not easily achieved, more than only the perception of the problems, what is needed is an architecture able to resolve it
- Role for civil society is to foster critical expertise, monitor developments and to place them on the agenda

No Time for Complacency

- Housing Booms (IMF 2014)+ search for Yield (ECB, May 2014 FSR)
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Table 1 Key risks to euro area financial stability

	Current level (colour) and recent change (arrow)*
1. Abrupt reversal of the global search for yield, amid pockets of illiquidity and likely asset price misalignments	↑ (medium-level systemic risk)
2. Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment	→ (medium-level systemic risk)
3. Re-emergence of sovereign debt sustainability concerns, stemming from insufficient common backstops, stalling policy reforms, and a prolonged period of low nominal growth	↓ (potential systemic risk)

pronounced systemic risk

medium-level systemic risk

potential systemic risk

*The colour indicates the current level of the risk which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next year and a half, based on the judgement of the ECB's staff. The arrows indicate whether this risk has intensified since the previous FSR.

Regulatory Activities after the last financial crisis

4 elements to be discussed

- Basel III: higher core capital requirements, systemic risk capital charges, counter-cyclical buffers (to be adopted nationally), liquidity regulation (implementation phase)
- G-SIFIs, Dodd-Frank Act and pending action in the UK and Euro-Zone: seeking to end too big to fail via resolution regimes and ring-fencing large banks (negotiation and implementation phase)
- Regulating Shadow Banking (implementation phase)
- Host of macroprudential policy regimes in the making: objective is to observe the build-up of systemic risk and to contain it by limiting the boom-bust cycle of the economy and increase the resilience of the system (negotiation and implementation phase)

Basel III part I: leverage

- Too high leverage increases the probability of excessive risk taking (Perrotti and Martynova 2012)→ seek good deleveraging to avoid crisis deleveraging
- Basel III Increases core capital charges. 4.5% of RWA Common Equity in 2019, capital conservation buffer, minimum total capital buffer 10.5% (Basel II 8%)
- While it keeps risk-weighted assets in its calculation for core capital requirements, it does apply tougher criteria of what qualifies as Tier 1 and tier 2 capital
- It introduces a simple leverage ratio (3%), which the US has increased to 4%

Cont'd

- National Countercyclical Capital Buffers: if a country judges to be approaching a peak, it can impose an additional 2.5% of core capital requirements upon its banks (problem of regulatory competition)
- To be supported by a reciprocity agreement installed in Basel III: banks from other countries will face equal surcharges upon loans made in these countries (problems of regulatory arbitrage)
- New accounting rules regarding loan loss provisioning, increasing the buffers of banks (need for consistency between American and International Standards)

Agenda for the future

- Basel III is a step in the right direction, but it starts from a very low level
- How high optimal equity should be is a discussion that should not distract from the fact that it is currently too low and that it needs to be raised beyond Basel III in a stepwise progression
- Admati-Hellwig argument (based on Modigliani-Miller Theorem): as risks cannot be diversified away through the funding structure, less risky modes of financing (i.e. more equity) should be as costly for banks as higher leverage
- Raising core capital over time, by forcing banks to withhold profits

Basel III part II: Liquidity regulation

- liquidity coverage ratio (banking conglomerate is liquid for one month): adopted, will come into force lastest by 2018
- and net stable funding ratio: banking conglomerate can survive for one year, even in a difficult year): currently in test phase, to be reevaluated this and next year
- Possible that the NSF will not be adopted, as it interferes too heavily with profitable business models of banks (maturity transformation): reliance on short-term funding as a problem

Ending too big to fail

- Banks that are seen as TBTF enjoy a subsidy due to cheaper borrowing costs. This fact and the (ensuing) merger wave in Banking has led to ever-larger banks (EU: 1996-2013 20 largest banks increase balance sheets by 139% of Eurozone GDP, Scientific Council ESRB 2014)
- Globally Systemic Financial Institutions face higher common equity tier charges to discourage greater size: 1-2.5% from 2016 onwards
- But concentration in banking sector has only increased, a sign that the penalties are not large enough) + process of European Integration indicates that there are bigger banks to come (Scientific Council ESRB 2014)

Resolution regimes

- Living will for all systemically important banks: the goal is that the next resolution of a transnational financial conglomerate will not prove as difficult as e.g. Lehman Brothers or Dexia, progress in Europe: ESRM
- problem is to know which banks will be systemically important in the next crisis (Geithner), Regime is untested: danger of false sense of security
- Attempt to install a credible bail-in regime in Eurozone by 01/2016, creating debt instruments explicitly engineered to carry the risk of default, right after equity (e.g. CoCo-bonds), only to be held by non-banks (s. e.g. Scientific Council of the Ministry of Finance 2014)

Ring-fencing

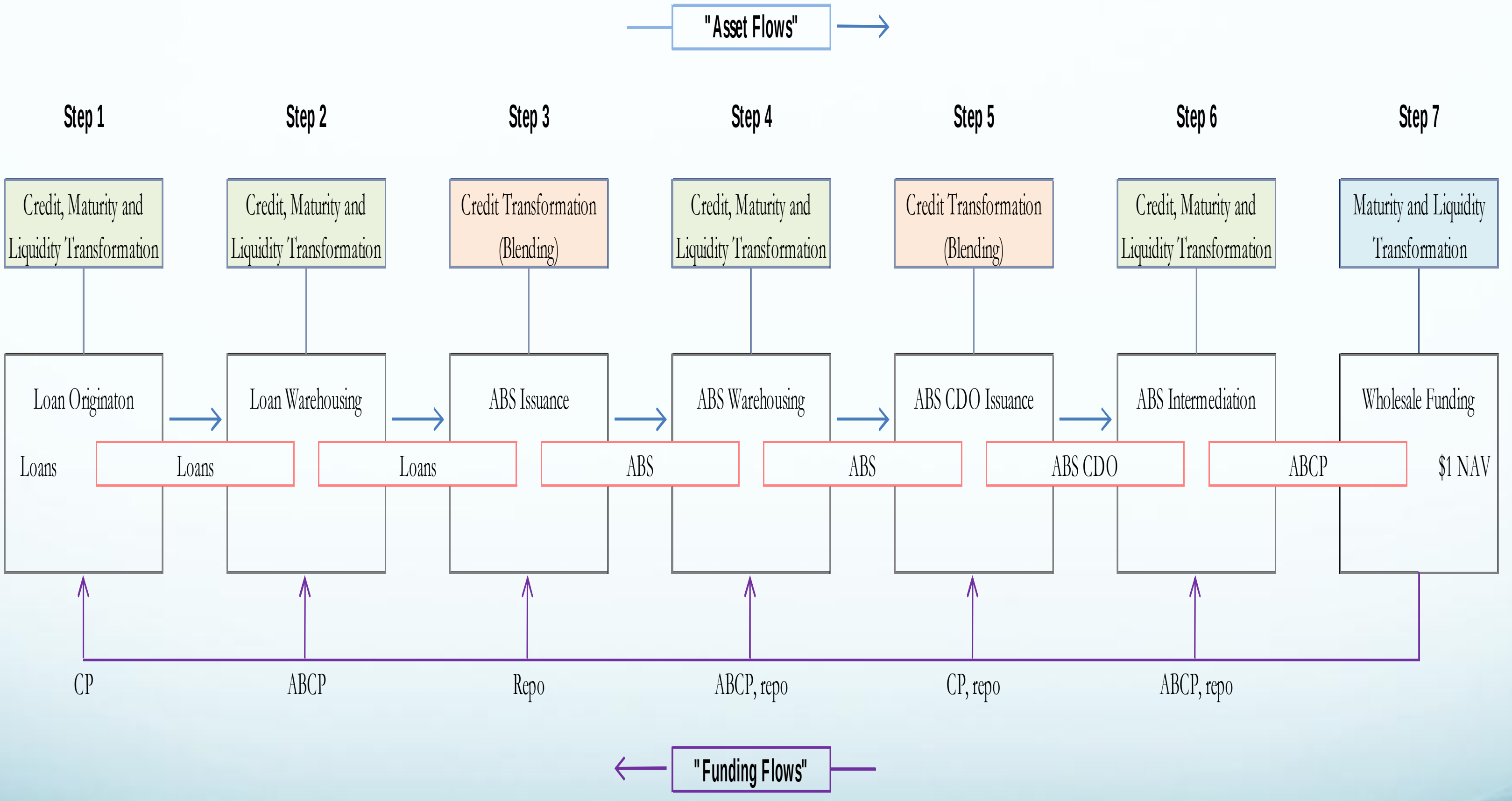
- Ring-Fencing: idea that safe deposit-business should not be used to subsidize risk-taking of investment banks (e.g. proprietary trading)
- Problem of demarcation: what is proprietary trading and what is market-making?
- Dodd-Frank Act enters into force in 2016
- Vickers Commission and Liikahnen Report/ Barnier Proposal have moved into implementation phase or are close to it (EU)

Shadow Banking and the problem of regulatory arbitrage

- Shadow Banking System: a long horizontally integrated chain of financial institutions refinancing long term assets with very short term liabilities (Pozsar et al 2010)
- Often sponsored by banks in such a way as to minimize regulatory costs (internal shadow banking system)
- Asset-Backed Commercial Papers and repos are financial products, engineered to give absolute security to MMF’s and Pension Funds

Exhibit 3: The Shadow Credit Intermediation Process

The shadow credit intermediation process consists of distinct steps. These steps for a credit intermediation chain that depending on the type and quality of credit involved may involve as little as 3 steps and as much as 7 or more steps. The shadow banking system conducts these steps in a strict sequential order. Each step is conducted by specific types of financial entities, which are funded by specific types of liabilities (see Table 2).



Source: Shadow Banking (Pozsar, Adrian, Ashcraft, Boesky (2010))

Shadow Banking System today

- Internal Shadow Banking System in its old form is dead as regulatory loopholes are closed, some of the main actors have disappeared (free-standing investment banks), others such as Money Market Funds and Hedge Funds involved in credit intermediation still exist
- Suggestions to place core capital requirements upon MMFs are strongly opposed, mainly in the US, but without the US there will be no regulation in the EU
- Hedge Funds are asked to provide more information to authorities and to markets
- Main refinancing mechanism (Repo) still exists, albeit volume is lower

What makes repo so attractive?

- Repurchasing Agreement is legally between a sale and a loan: e.g. an investment bank borrows money from a pension fund and posts Triple A tranches of a CDO as collateral, usually a daily arrangement
- The refinancing happens on a daily basis, and the lenders can require additional security by raising the haircut they apply to the collateral (overcollateralization)
- For borrowers: They allow financial agents to earn a few extra basis-points on ultra-safe assets, by borrowing money against them and investing it again
- For lenders: Due to the safe harbor clause, most repo-contracts permit the lender to immediately seize the collateral if the borrower defaults. He does not have to wait for bankruptcy proceedings to unfold, therefore lending is very safe (repos like money).

The Repo-Market and the Financial Crisis

- However, there is a systemic problem: the repo-market is subject to the boom and bust cycle (haircuts), which it itself further amplifies (firesales).
- The increase in hair-cut means a reduction in available funding in a crisis situation. Financial Institutions are forced to make position (sell assets) into a market where liquidity has already dried up (vicious circle of market and funding liquidity Brunnermeier and Pedersen 2008)
- Example of Lehman

Regulatory proposals after the crisis

- establish minimum haircut to lower the amplitude of the cycle: negotiation phase (FSB 2012)
- Problem that safe haven decreases the willingness of lenders to monitor assets, cheap and potentially unstable short-term funding, facilitating fire-sales is acknowledged (FSB 2012, 25), but limiting safe haven not seen as feasible due to technical problems
- Data initiative by FSB on bilateral repo market of 3 to 5 trillion dollar (lack of data)
- FSB seeks to influence ISDA to change contracts such that large scale early termination of financial contracts becomes more difficult (FSB 2013b, 15)

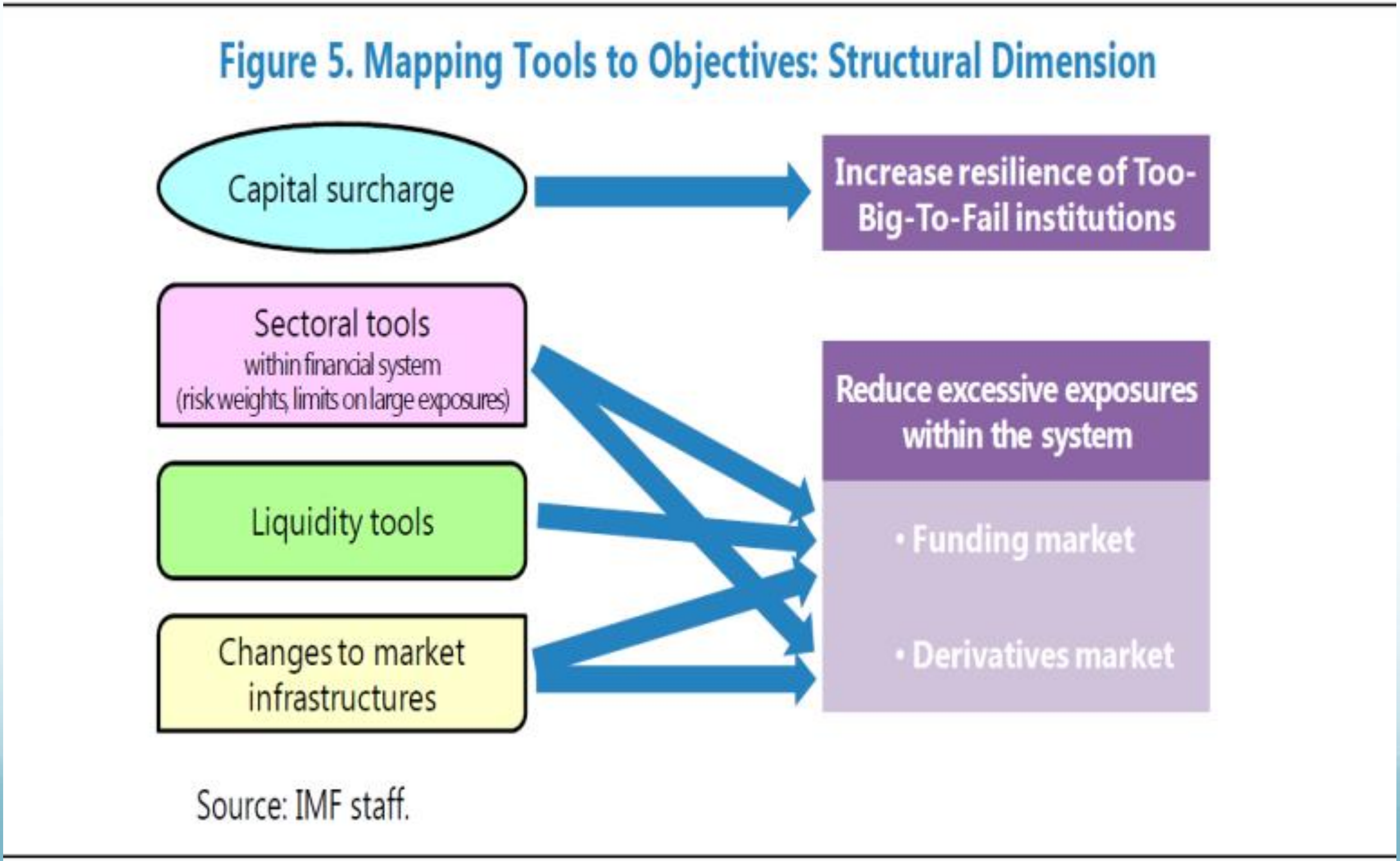
How to fix the problem of regulatory arbitrage?

- “By focusing on economic functions rather than legal forms, this framework is intended to allow authorities to capture innovations and adaptations that occur at or outside the bounds of banking regulation…, it is expected that the framework will provide a structured process to assess the need for extending the regulatory perimeter.” (FSB 2013c, 6f)
- A. how to know? (involvement of financial market actors and NGOs)
- B. How to act? (speed and scale)

Macroprudential Policies

- System-wide perspective on macro-financial interlinkages and the interconnections within the financial system
- Financial Cycle is acknowledged and taken into account in regulatory decision making
- No complete tool-kit yet, in the making, regulatory uncertainty as to the effects of regulatory action
- Uncertainty, the unpopularity of macroprudential policy decisions in boom times and problems of coordination lead to the problem of regulators possibly shying away from such measures

Structural Dimension



Examples

- Housing booms in several developed countries call for the introduction of higher LTV-ratios
- But problem of coordination across countries are difficult to address: it needs to be applied to all banks in all countries (home vs. host country supervision)
- IMF (2013) points out that in currency unions, there is a need for local action to adapt to the effects of common monetary policies
- However, national regulators face short term oriented politicians and a national finance industry pre-dominantly concerned by LTVs and other measures

Role of NGOs

- In order to strengthen the macroprudential paradigm, it needs to be defended against an intellectual climate that opposes regulation
- As regulation is cyclical, and we have arguably passed the peak, the proper installation of such a macroprudential regime that successfully constrains the volatility of the financial cycle may be the most important task a critical public can support (remark about IMF 2013 that it is not necessarily its role to cool overheating markets)
- NGO's should support counter-expertise (Finance Watch, SAFE Frankfurt) and demand regulators to intervene in markets that show evident signs of overheating
- To forge alliances with those members of financial community which stand to benefit from tighter systemic regulation (e.g. Sparkassen)

Role of NGOs in current stages of regulation	Banking Regulation	Shadow Banking	Repo Market	Macro-prudential regulation
Agenda Setting	Core capital requirements: Admati-Hellwig		Safe Haven Clause	Which tools are appropriate?
Negotiation				Which tools are appropriate?
Implementation	Too big to fail: we need measures that limit the size of institutions (higher G-SIFI charges?	Regulation of external Shadow Banking (MMFs and Hedge Funds)	Minimum Hair Cut for Repos, measures seen as too weak	How should tools look like? E.g. how to curb credit booms in housing?
Monitoring	Is ring-fencing working? Or is there arbitrage around it?	Acts of Regulatory Arbitrage		Overheating markets and cycles: voice concerns and push for action
Enforcement		Swift action to close regulatory loopholes		Discretion in using tools: push for enforcement

The End

- Thank you for your attention!
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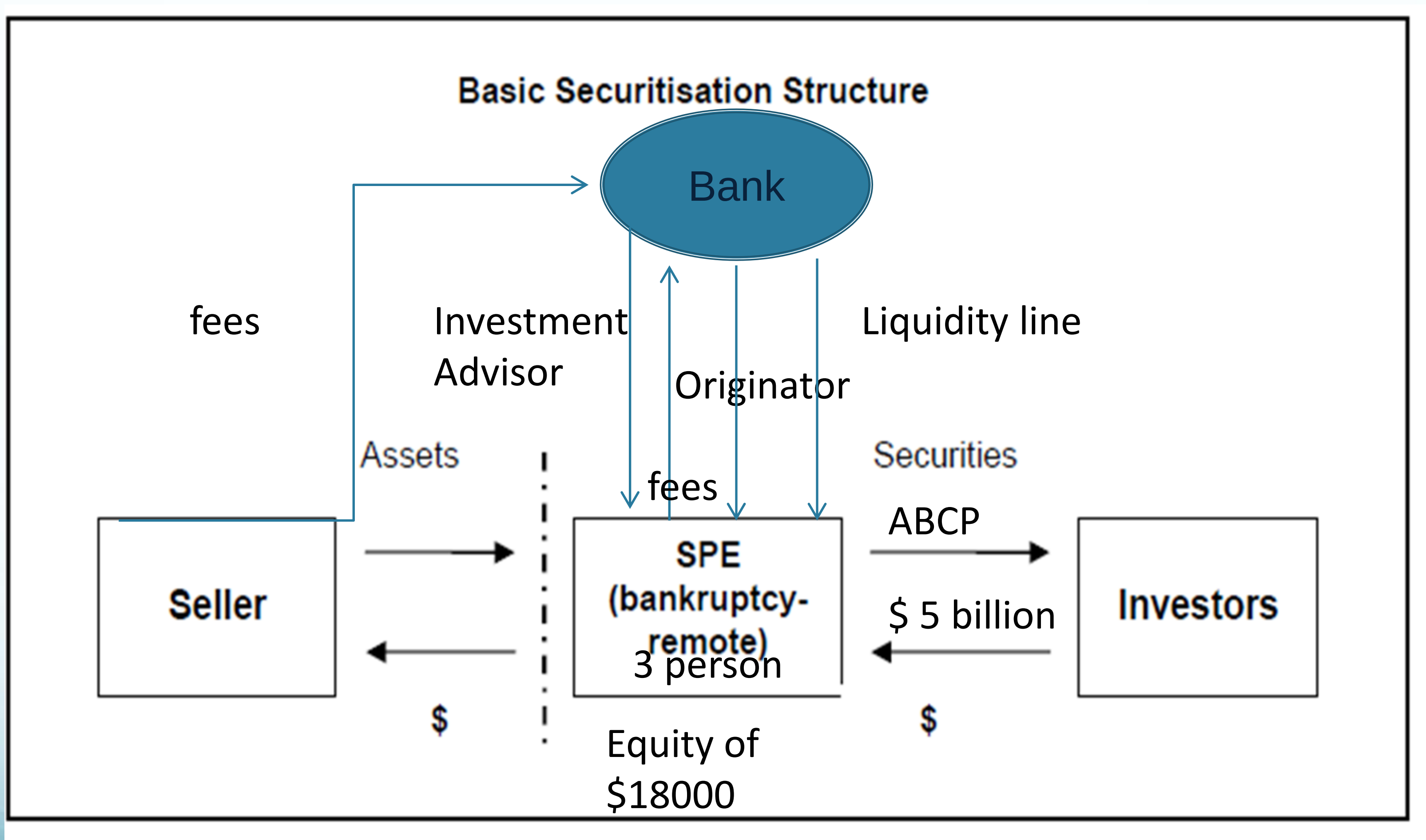
Regulatory Arbitrage in ABCP market: Perimeter Problem



Source Basel Committee 2009