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Financial Governance After the Great Recession: What Changed and What Didn't?

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The Nature of Financial Institutions

- **Alan Greenspan:** "The very nature of finance is that it cannot be profitable unless it is significantly leveraged... and as long as there is debt, there can be failure and contagion."

- **Hyman Minsky:** "Banks are profit maximizing organizations. The return on owners' equity is P/B = (P/A) (A/B)

  where P is profits, B is the book value of owners equity,

  and A is assets.

  Given this profit identity, bank management endeavors to increase profits per dollar of assets and assets per dollar of equity" (ie leverage).

- **Minsky** (quoting Henry Simons): "Banking is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks"

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Diverse Views on Governance

- **Greenspan**: Market Forces limit leverage and risk

"private regulation generally has proved far better at constraining excessive risk-taking than has government regulation."

- **Minsky**: Market Forces will produce excessive leverage

"a fundamental flaw exists in an economy with capitalist financial institutions, for no matter how ingenious and perceptive Central Bankers may be, the speculative and innovative elements of capitalism will eventually lead to financial usages and relations that are conducive to instability"

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Rethinking Market Governance After the Crisis

- Greenspan after the 2008 Financial Crisis:
- “I made a mistake in presuming that the self-interest of organizations, specifically banks, is such that they were best capable of protecting shareholders and equity in the firms.”
- “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief.”
- “I’ve found a flaw. I don’t know how significant or permanent it is. But I’ve been very distressed by that fact.”
- Alan Greenspan, October 22, 2008 Congressional Testimony

Major Post-Crisis Governance Innovations

- **<u>Higher Capital and Liquidity Ratios</u>**
  - Requires a Control of Principals on their Agents that does not exist in Financial Markets
  - Admitted by Alan Greenspan in “shocked disbelief”:
  - The Agents (Management of Financial Institutions) have no self-interest to protect Principals’ (the shareholders’) equity”
- **<u>“MacroPrudental” Regulation</u>**
  - Shift to Systemic Instability
    - But no theory of systemic instability
  - Not a New Idea: Already proposed by Minsky in 1960s and BIS in 1970s Latin American Debt crisis!

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Higher Bank Equity Capital

The New Role for Bank Capital

- <u>Traditionally Bank Equity was Operational Constraint</u>
  - Internal Monitoring - Skin in the game:
    - Equity Capital = Principal; Management = Agent
    - More Capital at Risk, Higher incentive for Principal to monitor Agent risk
  - External Monitoring – Market Discipline
    - Higher risk operations, lower equity multiples, higher capital costs, make it more costly to engage in risky behavior
- There is no evidence that either internal or external monitoring works
  - Requires balance sheet data immediacy and transparency that does not exist
  - And incentives may be inappropriate
    - Market evaluates footings and earnings growth, not risk
- <u>Really still a market-based solution</u>

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Reverses Traditional View of Role of Bank Equity Capital

- "Levels of capitalization appear to have had no direct causal relationship to the incidence of bank failure." (Voyta, 1976)
- "it is not possible to devise a generally acceptable measure of capital adequacy since the essential function of capital is to serve as a defense against the occurrence of unpredictable events." (Lucille Mayne, 1972)
- "The capital account of a bank is not adequate to maintain solvency in the event of a major liquidity crisis … Effective defense against ultimate crisis comes from lenders of last resort.
- This does not mean that the government is expected to bail out mismanaged institutions; *but neither should financial institutions be expected to be so overcapitalized as to bail out government's mismanagement of the economy.*
- As a matter of fact and practicality, the economic disaster case {STRESS TESTS?} should be excluded as a relevant scenario for capital adequacy purposes." (Voyta)

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Pro-cyclicality of Capital Ratios

- In 1934 bank capital ratios rose, as depositors withdrew funds
- In the 1920s Florida Real Estate Crisis the best predictor of failure was not capital, but a rapid rise in assets, deposits and share price
  - allowed banks to raise more capital more cheaply!
- J. Dimon: in the event of a crisis JPMChase would be unwilling to accept deposit transfers from weaker banks because of it would require higher capital
- Currently higher deposits incur higher capital charges, a factor pushing toward negative nominal interest rates
- Impact on Dealer Markets: 1987 Crisis no one answered the phone – no market liquidity

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Stability Comes from Stable Bank Incomes, not Bank Capital

- Minsky: Fragility is determined by "validation" of Bank Assets: Income flows to meet debt service
- Minsky: Big Government is a major component of Financial stability: setting a floor on incomes
- Traditional View: Standard risks met from current income and charge-offs
- Glass-Steagall: Guaranteed Bank incomes by granting a monopoly on deposit business and Req Q zero funding
- Do we have an metric to determine the appropriate level of bank Capital? 12%? 15%? 30%? 100%? Narrow Banking?
- After the 1980s Latin Debt Crisis insolvent US banks operated happily under Volcker's "regulatory forebearance"
- Or should we look at tradeoff between Bank Capital and Bank earnings: The structure of the Financial System

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MacroPrudential Regulation

What is MacroPrudential Regulation?

A. Haldane:

- “Since the crisis, financial regulation has become explicitly macro-prudential. This is an expression much-used, but generally little-understood.
- In a nutshell, it means that policymakers have begun using prudential means to meet macro-economic ends. Those macro-economic ends include tempering swings in credit and leverage – the classic credit cycle. Or, put differently, curbing the credit cycle appears to be an important ingredient of broadly-based macro-economic stability.

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Prudential Regulations for the Macro Economy

- "A growing consensus around three ideas:
  - Capital requirements need a countercyclical element to "dampen rather than amplify the financial and economic cycle" by "requiring buffers of resources to be built up in good times."
- … Greater emphasis on rules rather than supervisory discretion to counterbalance the political pressures on supervisors.
- … rules should include
  - leverage limits
  - liquidity buffers."

A. Persaud

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Developed in the 1970s by Lamfalussy at BIS

- According to Ivo Maes, the broad Bank for International Settlements "approach to financial stability, "marrying" the micro and macro-prudential dimensions of financial stability with its emphasis on the macro-prudential dimension, first came to the fore in the Cross Report on innovations in international banking. … this was the first published official document that used the term "macro-prudential"
- The Cross Report defined the macro-prudential domain as "the safety and soundness of the broad financial system and payments mechanism" (BIS, 1986, p. 2). …
- it focuses on the financial system as a whole, paying attention to the macroeconomic dimension of financial crises.
- it treats aggregate risk in the financial system as dependent on the collective behaviour of the financial institutions (which contrasts with the microprudential view, where financial institutions are regarded as having no influence on the global situation).

Any Regulation needs a Theory

- Minsky's early work (Commission on Money and Credit, Fed Study on the Discount Mechanism): Regulation requires an underlying theory to explain systemic crisis
- Keynesian or neoclassical general equilibrium theory provides no support
  - A theory of self-adjusting equilibrium provides little scope for discussion of systemic crisis since it could not occur.
  - It is difficult to formulate prudential regulations to dampen systemic financial crises if they only occur from random, external shocks or idiosyncratic, non-rational (fraudulent) behaviour.
- Justification for regulation was eradication of the disruptive behaviour of bad actors or mismanaged financial institutions
- This is MICROPRUDENTIAL REGULATION

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Minsky's Financial Instability Hypothesis as Basis for Regulation

- In Minsky's view regulation requires "A more complete description of the instability of an 'economy with banking'."
- needs to look behind the runs and analyze the structure of balance sheets, payment commitments and position-making activities.
- Position-making for a bank consists of the transactions undertaken to bring the cash position to the level required by regulation or bank management.
- **In the "position-making" view, bank failures do not arise simply because of incompetent or corrupt management.**
- They occur mainly because of the interdependence of payment commitments and position-making transactions across institutions and units."

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Cash flow Examinations to Support Macro Prudential Regulations

- Examination and analysis balance sheets based on the view that liquidity is not an innate attribute of an asset but rather that liquidity is a time related characteristic of an ongoing, continuing economic financial institution."

- Basic to the idea of liquidity as an attribute of an institution is the ability of the unit to fulfill its payment commitments.
- Any statement about a unit's liquidity, therefore depends upon estimating how its normal activities will generate both cash and payments, as well as the conditions under which its assets (including its ability to borrow as an "honorary" asset) can be transformed into cash.
- . . . Any statement about the liquidity of an institution depends upon assumptions about the behavior of the economy and financial markets. As the assumptions are changed, the estimate of the liquidity of the institutions will vary.

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Macro Prudential Regulations must be dynamic

- Regulatory structures eventually become obsolete or perverse.
- The normal, profit-seeking activities of agents lead to innovation in order to create new sources of profits; innovations can be in products, processes or finance.
- The search for profits also drives agents to avoid, evade and adapt to the structure of regulation and intervention put in place to constrain incoherence. In time this undermines the effectiveness of a regime of intervention that "stabilizes the unstable system."
- "As the monetary system, the financial system and the economy are always in the process of adapting to changing circumstances, the quest to get money and finance right may be a never ending struggle," because what is an appropriate structure at one time is not appropriate at another
- **Therefore if regulation is to remain effective, it must be reassessed frequently and made consistent with evolving market and financial structures.**

Importance of Institutional Change

- Minsky highlights the importance of institutional changes:
  - the emergence of "giant multi-billion dollar banks"
  - "fringe banking institutions and markets"
  - —should be a focal point of examinations
- To "enable the authorities to get a better handle on the operations" of these large banks and their linkages to "non-bank financial institutions and various short term financial markets."

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Structure of Financial Markets also undermines Impact of Regulation

- Impact of regulation eroded by what Minsky called “Money Manager Capitalism”
  - Principal - Agent controls distorted if Principals are represented by Investment managers who track short-term benchmark equity performance
    - And Principals pick managers on performance
  - Reinforces the incentive for Management to seek higher asset returns through more risky allocation
- Also eroded by use of stock-options to represent identity of Principal and Agent
  - Produces joint incentive to increase equity returns
- Both increase incentive to increase returns via more risky balance sheets

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What about current Macro Prudential Regulation?

Still No Theory of Systemic Crises/Cyclical behavior to support the macroprudential measures

- Still No Dynamic Response to liquidity and Countercyclical capital buffers
- Ignores perverse incentives, regulatory arbitrage
- One size fits all approach – that was the problem with Basel I and II
- Mistaken conception of "liquidity" buffer
- Still works on the basis of a single institution
  - Stress tests are still a very lonely affair
- Can prudential regulation provide support macro regulation? The Haldane Question. The Minsky rule exercise proves nothing.
- Minsky believed that macro and prudential regulations were contradictory.
- Better to have macro policy support prudential regulation

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Haldane's Ambidextrous Regulator and the Two Hands and the Minsky rule

- . One of the aims of macro-prudential policy is to act counter-cyclically on the credit cycle, constraining credit booms and cushioning busts. In this role, macro-prudential policy is complementing monetary policy in its role of stabilising the macro-economy. Macro-economic policy then becomes, in effect, two-handed or ambidextrous.
- The so-called Basel III reforms introduced for the first time a "Counter-cyclical Capital Buffer" (CCB) to be adjusted to counteract the credit cycle.
- It is also, inevitably, something of a step into the unknown. What will be the impact of changes to the CCB on credit and growth?
- Will the two arms of policy (monetary and macro-prudential) be better than one?
- And, if so, what institutional arrangements best deliver those benefits? Policy experience from the recent past and the present can shed light on these questions.
- The Minsky rule: Apply the CCB to the "Credit Gap"
  - (the ratio of credit-to-GDP, relative to its long run trend).

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Second Generation Macro Prudential Regulation Haldane

- "Yet if risk in the financial system, and activity in the wider economy, are shaped importantly by asset management behaviour and associated pro-cyclical swings in risk premia, then …
- Macro-prudential action may be justified even when leverage is not present …
- Modulating the price of risk, when this is materially mis-priced, could be every bit as important as controlling its quantity.

- This is the next frontier for macro-prudential policy – whether, and if so how best, to moderate excessive swings in risk premia across financial markets which risk damaging the financial system or wider economy.

- This will require new analytical techniques to measure risk premia and their impact. And it will require fresh thinking on new policy tools to moderate movements in these risk premia. This is, in effect, an agenda for the second-generation of macro-prudential policy frameworks"

Minskyan Alternative View

- Higher capital requirements raise B and reduce (A/B) (leverage)
- Increase dealer capital costs of market making
- Liquidity ratios reduce asset returns (+ collateral scarcity)
- ZIRP + QE reduce (P/A) balance sheet return on assets (RoA)
  - Reduce riskless earnings from riding the Government debt yield curve
  - Lower fixed income borrowing costs reduces business demand for loans
- Regulatory and Monetary Policy Act cumulatively to lower (P/B) (RoE)
- **Monetary Policy levers higher Regulatory capital buffers into greater incentives to increase returns on equity**
  - Higher RoE can be achieved via:
    - higher leverage,
    - financial innovation,
    - regulatory arbitrage,
    - Non-banking, off balance sheet activities
      - Insurance does it too: “captive reinsurance”
    - Fee and commission income

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But Greenspan Still Believes in Market Governance

- "An important collateral pay-off for higher equity in the years ahead could be a significant reduction in bank supervision and regulation. Lawmakers and regulators, need to be far less concerned about the quality of the banks loan and equity portfolios since any losses would be absorbed by shareholders, not taxpayers. This would enable the Dodd-Frank Act on financial regulation of 2010 to be shelved, ending its potential to distort markets — a potential seen in the recent decline in market liquidity and flexibility."
  - Alan Greenspan, "Higher capital is a less painful way to fix the banks" Financial Times, 18 August 2015, 11 (Italics added).

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Thank You

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