How Far Have We Come? Setbacks and Successes Since the Global Financial Crisis

Financial Policy Workshop, June 13, 2014

Global Economic Governance Programme Workshop Memo

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Conference organizers:

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Anat Admati, Goerge G. C. Parker Professor of Finance and Economics, Stanford University
Andrew Dilnot, Warden, Nuffield College, University of Oxford and Chair, UK Statistics Authority
Stephanie Flanders, JP Morgan and former Economics Editor, BBC
Charles Goodhart, Professor, Financial Markets Group, LSE and former Member, Monetary Policy Committee, Bank of England
Robert Jenkins, LBS and former Member, Interim Financial Policy Committee, Bank of England
Enrico Perotti, Professor, Faculty of Economics and Business, University of Amsterdam
Thierry Philipponnat, Secretary General, Finance Watch
Jean-Charles Rochet, Professor of Banking, University of Zurich
Peter Sands, Group Chief Executive, Standard Chartered
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Financial Policy Workshop

The global financial crisis, perhaps more than any other event in recent economic history, has highlighted the need for robust regulation and supervision of the financial system. The crisis laid bare a flawed system of financial governance, designed to minimize constraints on private-sector institutions and limited to a small fraction of financial activity, which did little to prevent the build-up of systemic risk in the years before the crisis. While the need for far-reaching reform is urgent, however, efforts to strengthen financial regulation in the five years since the crisis have experienced mixed fortunes. How much real progress has been made in reforming financial governance at the domestic, regional, and international levels?

These issues raise deeper questions about whether the discipline of economics can, in its current state, help us to truly make sense of the crisis and thus provide useful guidance to regulators seeking to prevent it from happening again. Standard economic models have been criticized for ignoring the possibility of financial instability, assuming away financial distortions created by the political system, and understating – or even denying – the benefits of robust financial regulation and supervision. Is economics out of touch with financial realities? What can be – and is being – done to address these problems?

This workshop memo seeks to shed light on these questions by drawing on insights from the *Financial Policy Workshop* co-hosted by Nuffield College and the Global Economic Governance Programme at Oxford University on 13th June 2014, which brought together a large number of distinguished academics, regulators, and members of the finance industry to discuss financial governance issues in the wake of the crisis. The memo highlights the key points and arguments made in the workshop's three panel sessions, before identifying key takeaways for the academic and policy-making community.

Guiding questions for the *Financial Policy Workshop* co-hosted by Nuffield College and the Global Economic Governance Programme at Oxford University

1. What have been the major setbacks and successes of financial regulation since the 2008 crisis?
2. On which questions do regulators lack guidance from formal economics?
3. What recent progress has economics achieved?

Assessing Progress in Post-Crisis Financial Reform

The post-crisis financial reform agenda has principally focused on two areas, namely banking and securities. There was a strong consensus among participants in the workshop's first panel session – which addressed the question: "What have been the major setbacks and successes of financial regulation since the 2008 crisis?" – that, within these areas, progress has been most disappointing where it is most needed. In the area of banking, the centrepiece of the international reform effort has been the Basel III agreement, a new set of standards determining the amount of capital banks hold against their assets as a "buffer" against unexpected losses. Several participants expressed the view that Basel III does not go far enough in reducing leverage and increasing liquidity in the banking system. In particular, the agreement's low capital requirements for collateralised debt obligations and other asset-based securities and weak leverage ratio – which allows banks to accumulate assets worth 33 times as much as their capital – were singled out for criticism. One former regulator blamed the lack of progress in this area on intense lobbying by the banking industry, which had managed to convince regulators to accept the "false dichotomy" that more equity and less debt in the banking system will result in lower economic growth.

Another issue that has received significant attention from regulators is the so-called "too-big-to-fail" (TBTF) problem. Participants pointed out that this problem has, if anything, become even more severe since the crisis, with bank assets growing faster than the economy in most of the developed world. This is, in part, because the problem has a self-reinforcing dynamic: the implicit government guarantee that comes with TBTF status allows banks to borrow at lower interest rates, which enables them, in turn, to expand their balance sheet. Several participants noted that, as part of this expansion, TBTF banks had entered the largely unregulated over-the-counter (OTC) derivatives market. Regulators in the US and Europe are currently seeking to strengthen the regulation of OTC derivatives by enhancing disclosure standards for transaction and pricing data, raising capital and margin requirements for swap dealers and other major market participants, and expanding the range of products that must be traded through central clearinghouses. While most participants felt that these measures are a step in the right direction, some believed that they are unlikely to stem the rapid and unsustainable growth of the OTC derivatives market because they fail to eliminate the funding subsidy received by TBTF banks.

Is there a solution to the TBTF problem? The Financial Stability Board's (FSB) latest regulatory proposals include requirements for additional loss absorbency, increased supervisory intensity, and more effective resolution mechanisms (involving so-called "bail-ins" that force bondholders to take a loss on their investment). One participant – a distinguished financial economist – argued that these proposals fail to tackle the root cause of the problem, namely, the increased levels of debt taken on TBTF banks as a result of their implicit government guarantee. The implication is that a viable long-term solution to the problem must involve restrictions on leverage; in this respect, the TBTF problem is closely intertwined with the problem of capital adequacy. A few participants also highlighted the importance of sound corporate governance in ensuring that TBTF banks refrain from excessive risk-taking. While some suggested that regulators should introduce more stringent standards for internal oversight, however, many felt that meaningful change was more likely to arise from a shift in the organizational culture of banks.

Can Economics Provide Regulatory Solutions?

A natural place for regulators to look for solutions to their problems is the discipline of economics. Yet regulators frequently complain that economics offers little practical advice about how to deal with the most pressing issues facing them. The second panel session turned to the question: "On which questions do regulators lack guidance from formal economics?" Participants focused on questions that remain to be addressed in three key areas of economics: macroeconomics, macroprudential analysis, and microeconomics. In the area of macroeconomics, three questions were highlighted: Is there still a future for inflation targeting? What is the appropriate balance between fiscal and monetary policy in economic crises? And why is credit growth faster than economic growth? The discussion mostly centred on the last question, with participants broadly agreeing that the more rapid growth of credit is a consequence of lending by TBTF banks, which has become increasingly profitable for them as their size has increased and hence their funding costs have declined.

In the relatively new field of macroprudential analysis, participants felt that economists had yet to answer basic questions: What is the principal aim of macroprudential policy? Can it be used to achieve macroeconomic policy objectives? How do macroprudential tools, such as caps on loan-to-value ratios and countercyclical capital requirements, interact with traditional macroeconomic policy instruments? The relationship between macroeconomic and macroprudential policy was a particular source of debate. Two central bankers argued that macroeconomic policy instruments, in particular interest rates, are too blunt to address problems in other areas of the economy, such as the financial sector. Conversely, macroprudential tools should focus not on the business cycle, like macroeconomic policy, but the credit cycle. Other participants, however, questioned whether allowing macroprudential tools to work in the opposite direction to macroeconomic policy instruments would have desirable outcomes. It is conceivable, for instance, that a reduction in interest rates and a simultaneous increase in caps on loan-to-value ratios might simply offset each other.

What are the key areas of post-crisis financial reform?

Financial reforms in the wake of the crisis have targeted two key areas: banking and securities. Within banking, the issue of capital adequacy has been at the forefront of the international reform effort, with a new set of standards – the Basel III agreement – finalized in 2011 and currently being implemented across the world. Despite raising capital requirements above pre-crisis levels, it has been criticized for not going far enough to prevent a repeat of the crisis. Another important issue is the so-called "too-big-to-fail" problem, which the Financial Stability Board (FSB) has sought to tackle with proposals for additional loss absorbency, increased supervisory intensity, and more effective resolution mechanisms. While the G20 has endorsed these proposals, however, member countries have yet to undertake the legislative reforms necessary to implement them. The FSB has also sought to address problems caused by the rapid growth of the shadow banking system. It is set to finalize new rules for enhanced data reporting and information disclosure by shadow banking entities by the end of 2014.

In the area of securities, the reform effort has focused on the over-the-counter (OTC) derivatives market. In particular, regulators have sought to increase transparency and efficiency in the market and reduce the potential for counterparty and systemic risk. Major reforms include enhanced disclosure standards for transactions and pricing data, increased capital and margin requirements for swap dealers and other major market participants, and an expansion in the range of products that must be traded through central clearinghouses. While important breakthroughs have been made, however, exemptions are likely to limit the scope of the new rules. In the US, for instance, derivatives based on foreign exchange are largely exempt. Perhaps equally worrying is the fact that most regulatory agencies lack sufficient resources to enforce the rules and firms are already modifying products to circumvent them. The success of the reform effort and the future of derivatives regulation thus remain uncertain.

Finally, in the area of microeconomics participants suggested that more attention be paid to questions about how financial institutions should be run: How much equity is enough for banks? Can debt be made into a good substitute for equity? How should employees of banks be paid? What is the socially optimal compensation structure? Is the limited liability structure problematic for banks? The issue of compensation divided opinion among participants. Most favoured bonus caps such as those implemented in the EU in the 2013 (as part of Capital Requirements Directive IV) on the grounds they encourage bankers to make decisions that are in the long-term interests of their employers. Some participants from the finance industry, however, objected that such measures are overly prescriptive and put banks at a competitive disadvantage to foreign rivals. They argued that only changes in the culture and internal governance of banks could affect incentives to engage in risk-taking.

How Economics is being "Fixed"

What, if anything, is being done to "fix" economics? The third panel session focused on the question: "What recent progress has economics achieved?" The wide-ranging discussion suggested that answer varies considerably across different areas of the discipline. One eminent macroeconomist lamented that his field had made no progress over the past 30 years. Traditional dynamic stochastic general equilibrium (DSGE) models are still widely used, for instance, despite the fact that they contain neither money nor banks and thus preclude the possibility of instability in the financial system. He described this as a "massive intellectual failure." Another participant noted that even specialized macroeconomic models that incorporate the financial sector continue to ignore variables that are central to systemic stability, such as bank equity and debt.

In other areas of economics, however, recent progress has been more encouraging. Participants praised innovations in behavioural finance that shed light on the way in which psychological, cognitive, social, and emotional factors influence market decisions. By highlighting and clarifying the bounds of individual rationality, these innovations have helped us to better understand why "collectively irrational" outcomes occur in financial markets. Participants were also optimistic about recent efforts to integrate traditional insights of banking theory – in particular, regarding the role of adverse selection and moral hazard in shaping bank behaviour – into mainstream financial economics.

Participants also stressed, however, that the crisis had revealed major gaps in banking theory. Models of the banking system have tended to underestimate the scale of regulatory arbitrage, largely because they have ignored new opportunities for circumventing regulations created by the expansion of the OTC derivatives market and financial innovations such as securitization. Moreover, they have generally assumed that the investment strategies of market actors are uncorrelated, leading them to misjudge levels of systemic risk. Encouragingly, cutting-edge research in banking theory is seeking to address these problems by incorporating new types of financial instruments and regulatory arbitrage strategies into models and developing more complex utility functions for market actors that take into account their incentives to mimic the behaviour of other actors. Participants were hopeful that this work would yield practical insights for regulators about how to minimize regulatory arbitrage and more accurately assess levels of systemic risk.

Key Takeaways…

…for policy-makers:

1. While progress in some areas of economic research has been limited, in others there have been important advances that can usefully inform policy-making:
    - Macroprudential analysis
    - Behavioural finance
    - Banking theory
2. Post-crisis financial reforms have not gone far enough:
    - Major international reform initiatives generally tackle symptoms rather than root causes.
    - Part of the explanation for the lack of overall progress is likely to be lobbying by the finance industry.

…for academics:

1. For research to be useful to policy-makers, key gaps must be addressed:
    - The exclusion of the financial sector from mainstream macroeconomic models.
    - The failure to identify new opportunities for regulatory arbitrage and to accurately model risk-taking strategies.
2. Policy-makers would benefit from clear guidance from economists on:
    - When to intervene to prevent excessive credit growth
    - How to effectively deploy macroprudential policy instruments.
    - How to design compensation structures that discourage excessive risk-taking.