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Reforming the Financial Sector in Light of the 2007-09 Crisis

Policy Options under Discussion

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Blankfein Testimony: Lightning Rod



The Incentives Problem



Problems Observed During the 2007-09 Financial Crisis

- **“The financial crisis had multiple, reinforcing causes, which in combination produced an economic and financial ‘perfect storm’:**
 - lax lending standards on the part of the government-sponsored enterprises, mortgage lenders and other consumer lenders;
 - excessive government subsidization of mortgages;
 - low interest rates;
 - imprudent consumer borrowing;
 - the widespread perception that (U.S.) housing prices would not fall;

Problems Observed During the 2007-09 Financial Crisis *(contd.)*

- the explosion of securitization;
 - the creation of complex, unregulated and badly understood financial products;
 - the continuous heavy inflow of savings from abroad;
 - excessive leverage and inadequate risk management at many financial institutions;
 - irresponsible behavior by rating agencies
 - the mispricing of risk.”
- **Serious weaknesses in advanced economy regulatory structures played a major role in the crisis.**

Main Issues for Regulatory Reform

- ❑ Raising Institutional Capital
- ❑ Changing Incentives to Reduce Inappropriate Risk-Taking
- ❑ Addressing Cyclicalities in Lending and Risk-Taking
- ❑ Addressing the “Too Big to Fail” Problem
- ❑ Addressing Capital Market Issues from Securitization and Derivatives
- ❑ Reforming the Approach to Regulation
- ❑ Harmonizing Regulation Across Countries

Capital Requirements for Financial Firms

Financial institutions need capital to be secure.

Capital requirements perform two functions:

- compulsory buffer and
- incentive function

From the perspective of a financial institution:

- Enough capital must be available to absorb losses without banks being forced to constrain lending.
- In particular, capital requirements should focus on common equity (“stock”), because other types of “capital” are only available in bankruptcy.

Capital Requirements for Financial Firms

- ❑ Impose capital requirements on all systemically-large financial institutions, regardless of type (e.g., commercial bank, investment bank, possibly hedge fund)
- ❑ Maintain an appropriate leverage ratio
- ❑ Have capital requirements increase more than proportionately with size
- ❑ Consider requiring institutions to obtain additional capital when certain indicators (such as credit default swap rates) exceed specified levels

Reducing Inappropriate Risk-Taking

- Basic objectives:
 - Strengthen incentives for institutions to consider risk in decision-making and improve risk management
 - Consider whether highly-risky activities should be limited to institutions that
 - (1) cannot obtain government insurance and recapitalization and
 - (2) are not “too big to fail”
 - Create ways to address the impact of economic cycles on risk taking

Strengthening Risk Management

- Increase supervision of senior risk managers and governance structures for risk management at financial institutions
- Strengthen skill and time commitments of non-executive directors
- Strengthen shareholder discipline over institutional strategies
- Include risk management factors in determining pay of executives and lending officers (see next slide)

Adjusting Compensation Practices to Discourage Excessive Risk-Taking

- Consider requiring that a significant part of any bonus, including bonuses from initiating new loans, be paid out only over a several year period, and that a significant part of any bonus be paid in company stock (equity)
- Link payment of deferred bonuses to the financial performance (of the firm) during the deferral period
- Consider adjusting measures of profitability used for determining bonuses to reflect the relative riskiness of different activities

Additional Proposals to Address Risk-Taking at Financial Institutions -1

- Require that banks obtain more of their funding from deposits and less from the inter-bank market and other “wholesale” sources)
 - Example: Proposed “core funding ratio” of the UK’s Financial Services Authority (FSA), to be developed on a bank-by-bank basis, possibly augmented by reference to a standard ratio

Additional Proposals to Address Risk-Taking at Financial Institutions -2

- Consider restricting activities allowed of government-insured institutions
 - Proposal 1: “Volcker” rule against propriety trading or investing or sponsoring hedge funds or private equity funds
 - Proposal 2: Limit banks to “utility” functions (e.g., deposit taking and classic lending), leaving investment banking and higher risk activities to uninsured institutions
 - Proposal 3: convert financial institutions into mutual funds, so that depositors know they bear risks from using an institution
- Note that objections have been raised to all proposals

Addressing Cyclical Factors in Risk-Taking

- Establish counter-cyclical capital requirements, liquidity rules, and ceilings on loan-to-deposit ratios. Cyclical indicators could include
 - above-average growth in credit or asset prices
 - growth in the (bank's) balance sheet
- Consider establishing counter-cyclical rules on mortgage loans as a percentage of appraised property value
- Consider requiring firms to develop a "capital buffer" during good times that could be drawn on during recessions

Addressing the “Too Big to Fail” Problem by Promoting Smaller Firms

- ❑ Establish a maximum “gross leverage ratio” (might limit the accumulation of assets at large firms)
- ❑ Introduce more-than-proportionate capital requirements (discourages overly large firms)
- ❑ Impose special fees on very large institutions, to help finance a “bailout” fund in the event of a future crisis (criticism: could the existence of a fund promote risky behavior?)
- ❑ Prevent institutions from engaging both in bank-like (deposit taking and lending) and non-bank functions (e.g., establishing hedge funds) – although some ask if this is feasible
- ❑ Establish absolute limits on institutional size (again, some questions on feasibility)

Handling Failures of Large Financial Institutions: Going Beyond Bankruptcy

- Underlying Problems:
 - Bank failures can have systemic economic effects
 - Traditional bankruptcy does not work well
- Some options
 - Require firms to have stand-by wind-up plans
 - Create special “resolution authority” to wind up large firms
 - Create a special insolvency regime for all financial firms, including current protections for depositors and brokerage customers
 - Ensure that shareholders, creditors, and managers all bear heavy losses if large institutions must close
 - Require automatic conversion of significant portions of debt into equity (stock) during bankruptcy

Addressing Capital Market Issues From Securitization and Derivatives

- ❑ Securitization can create problems, especially in mortgage markets
- ❑ Among derivatives, credit default swaps (CDSs) have important externalities
- ❑ Current CDS markets can create systemic risk through the possibility of a chain reaction of counterparty defaults
- ❑ Reforms should address the systemic risk by
 - improving information to market participants
 - facilitating the trading of financial derivatives

Reforming Securitization

- Prohibit or limit high-risk mortgage products and lending practices
- Strengthen representations, warranties, and repurchase obligations of those who originate loans or securities
- Make sponsors and originators disclose
 - Any interest they retain in securitized assets
 - Intentions regarding hedging of interests
 - Fees and other income to be earned
- Require all originators of securities and loans to retain a significant percentage of anything they originate

Reforming Derivatives

□ Derivatives:

- Over-the-counter derivative transactions should be recorded, and incentives should be provided to encourage derivatives to be traded on exchanges and in clearing houses
- Consider requiring all standardized derivatives to be traded on exchanges or at clearing houses
 - This could ensure payment for derivatives in the event a counter-party cannot perform
- Impose higher capital requirements on non-standard CDSs that are not traded on exchanges or clearing houses

Reforming Credit Rating Agencies

- ❑ Develop national, and preferably global, standards for credit rating agencies (CRAs)
- ❑ Enforce CRA regulation at the highest possible government level (e.g., national or EU-wide)
- ❑ Increase disclosure on how ratings are made
- ❑ Create incentives for more accurate ratings while avoiding government interference in the ratings process (e.g., decertify CRAs that persistently and egregiously underestimate default risk)
- ❑ Limit conflicts of interest by preventing CRAs from providing consulting services and insulating rating analysts from a CRA's commercial activities
- ❑ Address risks from using inaccurate credit ratings in regulation (e.g., using ratings for regulatory purposes)

Reforming the Approach to Regulation

- Make regulation focus on systemically-important institutions
 - Move away from simple regulation by type of institution and consider having one regulator for all systemically-important institutions
 - Example: In U.S., proposal for a “Financial Services Oversight Council,” setting policy in consult. with FRB
 - Treat SIVs and SPVs as being “on balance sheet”
- Require “major” unregulated institutions (e.g., hedge funds) to report certain information, to allow assessment of system-wide risks, and be able to regulate them if they become “bank like” or acquire systemic importance
- In countries with heavily fragmented regulatory regimes, some consolidation may be useful
 - Example: for U.S., many have suggested merging several of the existing regulators at the Federal level

Creating a Macro-Prudential Perspective toward Regulation

- Supplement prudential regulation of individual institutions with macro-prudential regulation
- Factors to consider include
 - Credit growth and pricing, borrower leverage
 - Changes in maturity mismatching and use of wholesale funding
 - Above-average growth in asset prices
 - Leverage within the system (including bank capital to asset ratios and margin requirements)
 - Whether unregulated institutions are operating so as to create systemic risk

Importance of an International Approach to Financial Regulation

- IMF Managing Director has noted the importance of recognizing cross-border implications of national regulatory reforms*
- Important for countries to be in consultation and consider how to harmonize regulation when implementing reforms
- “Coordination with other national regulators and cooperation with regional and international authorities is required.”**
- Note possibilities for “early warning systems” through IMF surveillance and national programs

*See Strauss-Kahn, Dominique, 2010, “Nations Must Think Globally on Finance Reform,” *Financial Times*, Feb. 18.

** Committee on Capital Markets Regulation, 2009, “Global Financial Crisis: A Plan for Regulatory Reform.”

Conclusions

- Regulation should address incentives and focus more on “systemic” issues
- Consider ways to
 - Increase bank capital
 - Limit leverage and incentives for inappropriate risk-taking
 - Reduce the cyclicalities of lending
 - Address “too big to fail” problem
 - Reform securitization, derivatives, credit rating agencies
 - Reform the regulatory structure
- Promote globally “harmonized” standards