Some preliminary proposals for re-regulating financial systems

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1. The aim of the paper is not to propose interventions and policies capable of stopping and reverting the current crisis. However, the political difficulties recently observed for the acceptance of systemic bail-outs also derive from not being accompanied by credible proposals for re-regulating the financial system. The set of sketchy suggestions we present goes in this direction; they are not thought to depict an ideal regulatory arrangement, but what in the present conditions may be feasible and worth to fight for. However, they are intended to show the direction towards which, in our opinion, a future regulation of financial systems should go.

2. The impressive increase in financial deepening of the last decades has been the product of financial liberalisation coupled by the shift to prudential regulatory schemes based on the Basel approach.

Financial deepening presents two main features. First, the ratio of financial assets to GDP, whose size has reached levels that are hardly justified by the necessities coming from the real sector. Second, an inverted pyramid of financial instruments has been built over an increasingly reduced primary and secondary liquidity base, producing a financial leverage, or multiplier, of an enormous magnitude.¹

Depending on market volatility, this multiplier is also subject to sudden and violent variations. When this occurs, calls of an unprecedented amount on primary and secondary liquidity follow, with banks and monetary authorities unable to cope timely with these demands. The same banking sector has taken part in increasing the leverage over primary liquidity. The practical disappearance of liquidity requirements and the inefficacy of capital requirements strongly increased the leverage measured with reference to un-weighted assets. The probability of strong phases of debt deflation has then increased. The violence of deleveraging may amplify the effects it produces on the real sector.

The level reached by financial deepening mainly depends on a higher degree of indebtedness of non financial sectors, such as households. The quest for shareholders

¹ For the effects of the evolution of the last decades on financial deepening see Borio (2007) and Schinasi (2007).
value' by financial firms unleashed by the liberalisation has heightened their interest for increasing the financial exposure by non financial positions. On the other hand, a higher profitability of financial firms gives them the ammunitions to pursue such a strategy. In order to be validated, higher real sector indebtedness requires the availability of higher cash flows in the future, i.e. higher rates of real growth. A disequilibrium may result when the potential rate of expansion of financial activity is higher than the long-term sustainable rate of growth. In the short-period the two may come to consistency by inflating the current value of financial assets, discounting larger expected debtors’ cash flows. The weakening of the liquidity constraint may in the short-period give a burst to economic activity; the point, however, is whether it is capable of increasing the growth potential at the same pace as the financial potential requires. If this is not so, after a while the insufficiency of aggregate cash flows to serve the debt leads to the necessity to refinance these positions with new debt, putting the entire system in a Ponzi position. Let’s remember that increasing the growth potential requires stressing the ability of the financial system not just to choose a correct allocation of resources; it should also unrealistically push for the continuous creation of new winning innovations in the real sector at a pace determined by its profitability. A larger discrepancy between the two potentials increases the probability of over-lending by the financial sector, thus of systemic risk mispricing.

In Minsky’s terminology, it is the financial system’s success in terms of a higher profitability that increases the fragility of the entire system.

The mispricing of risks has been also the result of qualitative features that have characterised the evolution of the financial systems. A predominant role in this respect has been played by the dissemination of financial instruments whose risks appeared and were evaluated as idiosyncratic, while their same dissemination rendered them systemic. This is particularly the case for derivative instruments offering financial operators insurance against market, credit and counterparty risks. From a systemic point of view the result has been an extreme correlation of risks, with the impossibility to honour these contracts in case of negative systemic events. In this context counterparty risk has become a leading player. This same process has produced long chains of risk transfer, making it difficult to understand the quantity and nature of risks many positions were taking and their concentration. The dissemination of risks is relevant for understanding the ways contagion takes; it is, however, the impossibility to provide endogenous systemic hedging to the financial sector that is at the heart of many current problems.

The ignorance on risk concentration expressed by supervisors is overplayed. Forbearance by anti-trust authorities and incentives and explicit actions by regulators and supervisors, seeking in the larger dimension gains for operational and risk management efficiency, paved the way for intermediaries that are simply too big. Beyond the medium-
large size those gains are no more visible, and diseconomies appear. Modern finance permits risk diversification well before reaching the size of the existing global players. While the concentration of risk in the big few pose serious systemic risks, too big to fail expectations lead markets to underestimate their idiosyncratic risks. The existing regulation does not provide defences against this type of risk concentration.

Many analyses, particularly the ones coming from the official front, emphasize the role of opacity, conflicts of interests and, more generally, of a wide set of moral hazard behaviours, many of which coming from the existing regulation. For the banking sector, a full adoption of Basel II, with some hardening of capital and liquidity buffers and more attention to governance issues, is regarded as enough to impede for the future the excesses that are seen to be at the heart of the current crisis. In our opinion, these analyses do not grasp the fundamental problems coming from the \textit{laissez faire} environment created by financial liberalisation and regulation: they look at the leaves while not considering the trunk. The current crisis is a sub-prime crisis for birth, not for its nature. The policy proposals consistent with this type of approach will leave financial systems exposed to the same class and level of fragility we have recently experienced.

3. It is then necessary to change the perspective taken by financial regulation.

If some types of risks are ‘hard to value’, pose systemic threats and no micro-hedging is effective to contain their consequences, simply they must not be created, or in any case it must be impeded their transformation into systemic ones. The micro-approach that has characterised the last decades -take all the risk you want but hedge them - requires being able to correctly measure those risks, that incentives for effective form of hedging exist, and that no systemic risks are endogenously created. Clearly this is not the case. The main game has been to create paper value, with financial returns in excess to the creation of value by the real system, and using resources just to force changes in the distribution of gains inside and outside the financial systems. The result is a net cost for the economy, with distortions in resource allocation, bubbles and bursts, and an enhanced instability of the real sector.

A substantially deregulated financial system also weakens the systemic defences against instability. As the same Basel’s Core Principles put it, a series of preconditions are necessary to make effective the banks’ supervision stemming from a prudential regulatory approach. Some of these preconditions have a pre-emptive nature, especially the ones based on institutional features; the others, mainly safety nets and fiscal and monetary policies, should produce a systemic cushion capable of absorbing and smoothing excesses of instability hitting the financial and real system. The fact is that the institutional preconditions singled out by the Core Principles are meant to easy the working of a liberalised financial system, not to impede its endogenous excesses, which may on the
contrary be left freer to operate. A higher instability, with its large and sudden call on liquidity and more virulent financial and real contagions, seriously strains the resources of safety nets, central banks and governments, up to the point that even the more advanced economies find it hard to cope with them. As we have shown elsewhere, Basel’s Second Pillar cannot and must not fill this void (Montanaro, Tonveronachi 2008).

It is then necessary to begin reverting past regulatory trends, going back to the fundamental role that the financial system should perform, i.e. allocating financial resources to the economy trying to assess at its best alternative risk/reward ratios. This requires, *inter alia*, putting a brake on excessive financial expansions, limit the size of financial intermediaries, and restricting risks to typologies and levels that can be managed at the micro-level (intermediaries), and monitored and contained at a systemic level (authorities). Facing the necessity of costly systemic bail-outs, structural regulatory measures must be reinserted in our tool box.

4. Let’s then try to put forward some tentative re-regulatory suggestions for intermediaries and markets.

**INTERMEDIARIES**

I. Reducing regulatory arbitrage and the ‘outsourcing’ of regulation

I.1 All leveraged financial institutions must be subject to a uniform regulation. The proposals that follow require that this condition is satisfied.

I.2 Regulation must cancel any reference to external ratings.

II. Re-equilibrating regulatory risk hedging, but containing their costs

II.1 Limits maturity mismatch

II.2 High liquidity requirements, with liquidity from now on defined as cash and public bonds with sovereign risk not higher than the home country’s one. These requirements are measured with reference to total assets, including off-balance sheet activities.

II.3 The liquidity requirement is set as an increasing function of the customer funding gap, defined as \((\text{Loans} - \text{Retail deposits})/\text{Loans}\).

II.4 The adoption of Basel’s IRB methods must be discouraged, especially in weaker financial systems. In any case, their adoption and the consequent Supervisory Review Process must be significantly simplified in order to contain regulatory costs (see also point. V.3)
III. Going back to sustainable levels of financial deepening

III.1 Independently of the specific regulatory scheme, supervisory capital only refers to its Tier 1 definition, and capital requirements must computed with reference to all assets, off-balance sheet items included.

III.2 Independently of the adoption of Basel type capital requirements, a maximum level for leverage is imposed. The leverage is computed as the ratio of all non-weighted assets to free capital.

III.3 The liquidity requirements proposed in point II.2 must be consistent with extreme events and ordinary liquidity interventions by the central bank. Liquidity requirements held against the trading book must be equal to the maximum value of potential losses.

IV Contrasting procyclicality

IV.1 The liquidity ratios, of which in II.2 and III.3, are a direct function of the rate of growth of all assets, net of liquid ones. Liquidity requirements in II.3 have a built-in mechanism against procyclicality.

IV.2 Dynamic provisions are introduced as a direct function of net income.

IV.3 Fair value accounting must be applied to financial institutions only with reference to the trading book. Moreover, substantial changes are necessary regarding prudential filters, up to now partly and not uniformly adopted in Europe. They must work for both upside and downside changes. The previous proposals concerning liquidity buffers and specific provisions lead to build up an ample cushion of reserves whose amount changes in the same direction as fair values. Capitalisation and lending capacity are thus shielded from the inherent procyclicality of fair value accounting.

V Reducing the endogenous creation of systemic risks

V.1 In order to reduce incentives for intermediaries to become too big, three different levels are established for the leverage of which in III.2. Larger the size, lower the maximum permitted leverage.

V.2 No hedging and insurance coverage must be given by financial intermediaries and insurance companies to other intermediaries and insurance companies.

V.3 Savings in capital, liquidity and provisions requirements coming from risk transfer is admitted only when all risks are integrally shifted to other unconnected subjects.

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2 More precisely we refer to the Upper Tier 1, which includes only equity capital and disclosed reserves.

3 Free capital is defined as Upper Tier 1 net of fixed assets.

4 Prudential filters impede that notional fluctuations of value of the concerned items are reported as changes of capital or income.
Securitisation leads to save capital only if no residual risk remains and no new obligations are linked to it. Risk mitigation contracts, as restricted in V.2, do not lead to changes in capital, liquidity and provisions requirements. A significant simplification results when IRB methods are employed.

V.4 Financial intermediaries are not allowed to enter into OTC contracts, and anyway into derivative contracts not exchanged in organised markets.

V.5 Contrary to the current trend, the participation of non financial entities in the capital of regulated financial firms is not allowed.

MARKETS

VI. Reducing and stabilising financial and embedded (instrument) leverage

VI.1 Minimum percentages for haircuts and margins must be observed, at levels consistent with extreme illiquidity events in the markets.

5. The severity of these proposals also depends on the levels of some of the suggested requirements. The political bargaining should concern these levels and not the nature of the proposed measures. The traverse from the current system to the new one should have the following priorities:
- The extension of banking regulation to all financial leveraged intermediaries.
- Liquidity reserves.
- Non-weighted maximum leverage on Upper Tier 1.

References

