

IPD Policy Brief for UN Commission on Financial Crisis and Policy Response, With  
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PROPOSALS FOR REGULATORY REFORM

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**Introduction**

It is useful to put crises and responses to it into a historical context. Firstly, is it important to stress that after the Great Depression, the financial sector – particularly, but not only, in the US – was re-regulated carefully, most notably by the Glass-Steagall Act of 1933. During the next 40 years, the financial sector was closely regulated, capital accounts around the world were fairly closed, and there were practically no financial crises. Since the 1970's, and especially during the 1980's and 1990's, there was massive de-regulation, both at national and international level. Since the 1980's, there have been very frequent and very deep financial crises, both in the developing and developed world.

Though crises have complex causes, it seems evident that liberalization of financial markets, especially if not accompanied by appropriate regulation, seems to almost always lead to costly and damaging crises (see for example, Kaminski and Reinhart, 1999), for empirical evidence) This implies that financial crises are not inevitable, but may be prevented or ameliorated, by appropriate public policy, and especially by effective regulation.

The only silver lining that appears during these costly crises – such as the current one – is that they provide a political opportunity to carry out desirable regulatory reforms. The task of improving regulation is an urgent one because the political window of opportunity is a narrow one and can close quickly. This was, for example, an important lesson learned in the wake of the East Asian crises. Even though there was such a major debate about reforming the international financial architecture, including regulation – during and after the crises – in practice very little progress was actually made once the crises was contained, (Griffith-Jones and Ocampo, 2003).

However, the current crisis originated – and is extremely deep – in the developed economies, and particularly in the United States. It has led to massive bail-outs and very costly public recapitalizations of many financial institutions in those countries. The crisis threatens to lead to an unacceptably serious recession in developed countries and a massive slowdown globally. As a consequence, political appetite for more and better regulation is significant. Indeed, steps are beginning to be taken to improve regulation.

The key question in policy circles at present is therefore not whether to regulate, but how best to do it. In thinking about the future shape of the financial system and its regulation, it is important to be clear about its purpose. The financial sector should be seen as a means to an end (Stiglitz, 2008); it should serve the real economy, and thus the needs of households

and enterprises, to consume and invest. On the positive side, governments should encourage the financial sector to create financial innovations that support growth in a sustainable way. Governments should also use regulation to avoid systemic risk being generated, thus preventing future crises, that can be so negative for the real economy.

The principles on which financial regulation needs to be built are, to an important extent, based on the causes of this and previous crises. The first relates to the inherent flaws in the way that banking and capital markets operate; in particular, the main market failure of those markets is their boom-bust pattern, linked – as market participants themselves describe it – to cycles of greed and fear. To help overcome these pro-cyclical patterns of behaviour, a first principle of regulation needs to be that of counter-cyclicality.

The second major cause of crises is rapid liberalization within and across countries, accompanied by insufficient, incomplete and inappropriate financial regulation. Indeed, the excesses of financial liberalization and the major mistakes of regulation, as well as its incompleteness, imply a massive policy failure.

### **Principles of regulation**

To overcome the failures – both of markets and of policy – that have been major factors contributing to the crisis, two key principles of regulation need to be followed: one is that of introducing counter-cyclicality at the heart of regulation, the second is the need for regulation to be comprehensive, so that the domain of regulation coincides with the domain of the market.

#### a) Comprehensiveness

We will start first with the principle of comprehensiveness.

Financial systems – both nationally and internationally – have undergone very large changes. Regulation has clearly not kept up.

In the United States, and also in other developed countries like the UK, there had been a massive shift of savings from banks to capital markets. As pointed out in d’Arista and Griffith-Jones (2008), only 25% of the US financial systems’ assets belonged to commercial banks in 2007.

However, commercial banks were the only part of the financial system that were regulated for capital requirements and even that regulation was partial as off-balance sheet instruments, such as Structured Investment Vehicles, were practically unregulated. Investment banks were very lightly regulated. Other financial actors, like hedge funds, were not at all regulated. Neither were powerful rating agencies, nor were many mortgage lenders. For some of the financial instruments, like Over-the-Counter (OTC) derivatives that grew the most in the last decade to astronomical levels, there was no transparency and even less regulation. Off-shore centres are subject to no or extremely light regulation.

A massive “shadow financial system” was allowed to emerge, which has no or very little transparency or regulation. Indeed, regulatory arbitrage – the wish to avoid regulations –

often drove, or at least strongly encouraged, the growth of this financial activity and of related risk taking. Thus, many of the problems that caused the financial crisis arose mainly in institutions (e.g. mortgage lenders) or instruments (e.g. credit default swaps) that were not regulated. This is similar to many previous developing country financial crises, where also the most liberalized and unregulated parts of the financial system were major causes of crises.

In capital markets, there was practically no formal regulation. Private actors, such as insurance companies, pretended they were able to sell systemic risk insurance, like credit default swaps (CDS). Some of those major insurance companies, like AIG in the US, had to be rescued and effectively nationalized, as they essentially became bankrupt during the crisis. This was because they did not have sufficient capital and reserves to fulfil credit swap insurance contracts that had a massive amount of systemic risk. Indeed, no entity – except the governments – was capable of fulfilling credibly such a contract once the crisis spread. Thus, the government not only became the lender of last resort, but also the insurer of last resort, because it had not previously exercised regulation to limit the risk that afterwards it had to assume.

To summarize, regulation has to be comprehensive, both nationally and internationally, so that the domain of the regulator coincides with the domain of the market; if not, regulatory arbitrage will be inevitable. Another reason – illustrated by recent events, when bail-outs and rescues have been massive – is that there is a need to have comprehensive regulation to avoid moral hazard.

It needs to be pointed out that most developing countries are bank based; even when they have developed capital markets, the commercial banks tend to be the largest players. Thus, most savings tends to be in the banking sector. However, other actors like non-financial corporations often play an important financial role; for example they can provide large volumes of credit or speculate on currencies. Therefore there are challenges for comprehensive regulation in emerging countries, but these may be somewhat different from those in developed countries. Developing countries also need to have a keen interest in comprehensive regulation in developed countries, as problems in those countries financial markets can spill over to them, especially in crises.

A pre-condition for effective comprehensive regulation is comprehensive transparency. Thus, for example, Over-the-Counter derivatives should all be brought on the exchanges (even if this implies certain micro-economic costs, we believe these would be far smaller than the benefits for limiting systemic risk of bringing OTC derivatives on the exchanges). Off-balance sheets instruments, like Structured Investment Vehicles, should be brought into balance sheets, and on-site inspection of banks and other financial institutions should be expanded. The fact that, in developed countries, governments now own capital in many financial institutions should facilitate this process.

Comprehensive regulation should relate both to liquidity and solvency. As regards solvency, equivalent regulation of different actors, instruments and activities should aim at equivalent limits on leverage, as excessive leverage has been such a major source of systemic risk. However, as the longevity of funding is an important variable, it may be desirable to restrict leverage (and require more capital) for assets funded by short-term liabilities. This will not

just protect the solvency of financial institutions, but also encourage them to seek more long term funding. Furthermore account needs to be taken of how different activities and institutions can generate systemic risk in dissimilar ways.

## b) Counter-cyclical

As pointed out, the most important market failure in financial markets through the ages is their pro-cyclical. In fact, risk is mainly generated in the booms, even though it becomes apparent in the bust. Therefore, the time for regulators to act – to prevent excessive risk taking – is precisely in the boom. Indeed, one of their key functions is “to take away the punch-bowl when the party is at its best.” As a consequence, financial regulation has to follow the principle of counter-cyclical. This will both help ensure banks build up resources in good times, to help cushion the shock on them in bad times-“protecting banks from the economic cycle”- and also moderate lending in good times as well as facilitate lending in the downturn,-“protect the cycle from banks”(Gieve,2008). Countercyclical regulation needs to happen through simple rules which cannot be easily changed by regulators so they will not become “captured” by the general over-enthusiasm that characterizes booms and relax regulatory standards nor by capture by vested interests.

### i) Counter-cyclical regulation of provisions and/or capital

Counter-cyclical bank regulation can be easily introduced, either through banks' provisions or through their capital. Introducing counter-cyclical bank provisions has already been successfully done for some time in Spain and Portugal showing that it is feasible. Recently, Switzerland has introduced countercyclical regulations. The Spanish system requires higher general provisions when credit grows more than the historical average, linking provisioning to the credit and business cycle. This both discourages (though does not eliminate) excessive lending in booms and strengthens the banks for bad times, when they can draw on the general provisions. An advantage is that it does not require precise estimates of the length of the cycle, or predictions when the cycle will turn; it also can be capped, to avoid very large growth of reserves in a long upswing.

According to the Deputy Governor of the Bank of England (Gieve, op cit, 2008), as a result of this system of provisioning, Spanish banks were better placed than their counterparts in other countries to absorb losses, without eating into their core capital; indeed, the Bank of Spain estimates the 2008 level of general provisions could absorb losses associated with a doubtful asset ratio of 9%,(the current level is 1.5%).

Introducing counter-cyclical (dynamic) provisions in Spain was facilitated by the fact that the design of accounting rules was under the authority of the Central Bank of Spain. This helped overcome the issue that accountants do not readily accept the concept of “latent” or expected losses, on which the Spanish system is based, preferring to focus on actual losses, the latter information being more relevant for short-term investors. However, accounting principles should be designed in ways that balance the short-term needs of investors with those of individual and systemic bank stability. Unfortunately, even the Bank of Spain was obliged to make some changes to its dynamic provisioning when the European Union in 2005 adopted standards issued by the International Accounting Standards Board. It is paradoxical that just as Bank of Spain dynamic provisions were being increasingly studied

and praised internationally they had to be changed somewhat to comply with accounting standards.

An alternative approach for counter-cyclical bank regulation is through capital. Here, Goodhart and Persaud, G-P, (2008) have presented a specific proposal: increasing Basle II capital requirements by a ratio linked to recent growth of total banks' assets. This provides a clear and simple rule for introducing counter-cyclicality into regulation of banks. Another virtue of this proposal is that it could be fairly easily implemented, in that it builds on Basle II. Finally, it has the advantage that having fairly similar effects, it does not face the accounting difficulties outlined above for provisioning.

In this proposal, each bank would have a basic allowance of asset growth, linked to macro-economic variables, such as inflation and the long-run economic growth rate. It would measure actual growth of bank assets as a weighted average of annual growth (with higher weights for recent growth).

Two issues arise. Should the focus just be on increase in total bank assets, or should there also be some weighting for excessive growth of bank lending in specific sectors that have grown particularly rapidly (such as recently to real estate)? Often crises have arisen due to excessive lending during boom times to particular sectors or countries (e.g. emerging economies). However, most systemic bank failures have also been preceded by excessive growth of total bank assets.

Secondly, such a simple non risk based rule could potentially penalize banks that increase their assets through lending to less risky borrowers than their competitors do (Bank of England 2008). However, by integrating this with a reformed Basle II, as the G-P proposal does, this problem could be overcome

Finally, for any such regulatory change, there is the crucial issue of timing. It seems key to approve such changes soon, while the appetite for regulatory reform remains high. However, their introduction should be done with a lag, so as to avoid increased capital requirements (especially linked to the weighting given to growth in recent years in the G-P formula, which would be high) putting pressure on currently weak banks and accentuating the credit crunch. Indeed, leverage has to be reduced, but this needs to be done gradually.

Some of the least regulated parts of the financial system may have some of the strongest pro-cyclical impacts, including on emerging economies. One such example is the role that hedge funds and derivatives play in carry trade; there is increasing empirical evidence that such carry trade has very pro-cyclical effects (on over or under shooting) of exchange rates of both developed and developing economies, with negative effects often on the real economy.

For regulation to be comprehensive, as argued above, there should be minimum capital requirements for all derivatives dealers and minimum collateral requirements for all derivatives transactions, so as to reduce leverage and lower systemic risk. Collateral requirements for financial transactions function much like capital requirements for banks.

An issue to explore is whether for example regulation of derivatives' collateral and capital

requirements should also have counter-cyclical elements. This would seem desirable. It would imply that when derivatives positions, either long or short, were growing excessively (for example, well beyond historical averages), collateral and capital requirements could be increased.

An important additional reason to extend countercyclical regulation to non bank actors and activities is that if countercyclical regulation were only implemented for banks, this would – by increasing the cost of their lending in booms-create incentives for the growth of intermediation outside the banks, which could be undesirable.

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