Two Years into the Crisis: What Lessons May Be Drawn?

24 November 2010
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1. Introduction

- Who was guilty for this crisis?

1) Change in the behaviour of banks:
   - innovation (e.g., securitization)
   - stark increase in requested ROE
   - increase of leverage
   - more trading, less credit
1. Introduction

Evolution of UK banks’ ROE

1. Introduction

Evolution of equity/asset ratio

1. Introduction

Share of trading assets in main world banks (source BoE)
1. Introduction

Size of bank’s balance sheets w.r.t. GDP in UK

1. Introduction

- Who was guilty for this crisis?

2) Macroeconomic disequilibria
   - trade deficit USA- China and excess saving in China
   - huge indebtedness of USA
1. Introduction

Trade surplus China/USA ($bn)
1. Introduction
1. Introduction

3) Weak regulation and inadequate prudential control:
   - Bale II gives too much leeway to banks
   - prudential controlers often too complacent with or to close to bankers

4) Insufficient risk management and too strong belief in models

5) Weak corporate governance: role and composition of Board of Directors
6) Remuneration policy leading to moral hazard

7) IAS rules are inadequate when markets are illiquid and pricing is inefficient

8) Social disequilibrium in the USA leading to overindebteness
1. Introduction

Where do we stand after two years?

- Has been successful: bank’s leverage
- Has made some big efforts: financial regulation
- Could do (much) better:
  - Composition and role of BoD’s
  - Risk management
  - Remuneration policy and moral hazard
- Utterly unaddressed:
  - Macroeconomic disequilibrium
  - Social disequilibrium in the USA
2. The New Regulatory Environment and Some Unanswered Questions

- Basle III (+ Swiss and (probable) UK « finish »)
- Dodd-Frank Wall Street Reform and Consumer Protection Act (with Volker’s rule)
- European Systemic Risk Council
- Project of Directive on Alternative Investments
- Remuneration policy
2. The New Regulatory Environment and Some Unanswered Questions

- New regulations are a big improvement on existing ones
- Leave nevertheless many unanswered questions or raise new ones, i.a.:
  - Arbitrage between banks and shadow banks
  - Arbitrage between Europe and USA (and BRIC soon?)
  - How to take care of failing banks (opposition between US and European approaches)
  - Credit agencies hardly affected by the regulation
  - Moral hazard has never been so high...
2. The New Regulatory Environment and Some Unanswered Questions

- New regulation has been – as always – reactive to a crisis and fails entirely to answer some fundamental questions:
  - what is the precise added value of the banking sector and what role should it play in our societies?
  - how can central banks burst financial bubbles?
  - how can moral hazard be significantly reduced?
3. What Role for the Financial Sector?

- Standard roles:
  - channel savings into investment
  - transferring risks
  - smoothing life-cycle consumption (maturity transformation)
  - effecting payments
  - market making

- Difficult to see where the reward comes from and whether it is justified
3. What Role for the Financial Sector?

- Bank credit has a more limited role in economic expansion than claimed.
- Much credit smooths life-cycle consumption: yields welfare benefits but does not spur long-term investment.
- Credit targeted to finance existing real-estate has little value-added and potentially feed bubbles.
3. What Role for the Financial Sector?

- Market-making and providing liquidity is valuable but up to a point only
3. What Role for the Financial Sector?

- Axiom that more trading and liquidity enhancement is beneficial must be rejected as it can destabilize the financial system
- If we want a more stable banking system trading activities in retail banks need to be curtailed
- Europe should adopt a legislation similar to the Volcker’s rule
4. Can Central Banks Burst Bubbles?

1) How can CB’s detect bubbles?

1.1 Problem with the theoretical framework

- Lack of theoretical tools
- Efficient Market Hypothesis still dominates but has proven inadequate
- Macroeconomic models do not take into account financial markets
- Answer lies probably in inefficient market theory but no universally acceptable model of thought has yet emerged
4. Can Central Banks Burst Bubbles?

1) How can CB’s detect bubbles?

1.1 Problem with the quality of the control

- Over-reliance on highly sophisticated risk management models
- Common sense is sometimes absent in prudential control...
4. Can Central Banks Burst Bubbles?

2) How can CB’s burst bubbles?

- (Recent) History show that words of caution and early warnings are not enough
- Interest rate is the only instrument in the hands of BC’s: not enough to pursue two goals (consumer price- and asset price stability) at the same time
- Need to create some new institutional features in order to constrain credit growth or to curb speculation when necessary - although politically unpopular
5. Moral Hazard (Always and Again)

- Moral hazard in banking leads to huge negative externalities. How do we internalize these?
- Moral hazard has never been so high as today: no one would risk another Lehman-type failure, Fed and ECB are intervening, creation of last resort funds for sovereign risk, etc.
- Politicians will eventually accept the new regulation to be gradually relaxed to spur growth
- Big banks have grown bigger after the crisis and thus even bigger to fail than previously
5. Moral Hazard (Always and Again)

- To prevent the bank management from «gaming the State», one should force it to lose a very substantial part of its remuneration or accumulated wealth in case of default (5 or 10 years of remuneration?)
- The governance of banks must be strengthened: impose the presence of risk specialists on the board of directors
- Prudential controller should use its stick more often
New regulation goes in the right direction and offers a much higher level of safety but...

Regulatory arbitrage subsists at industry- and at country-level

One should curb trading activities in European banks

CB’s are ill-equipped to detect and burst bubbles

Moral hazard still has to be properly dealt with