The Global Financial Crisis: To Regulate or not to Regulate?

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Global financial stability

- **What has been core nature of the financial crisis?**

  "…The details can be insanely complex, but the basics are fairly simple. The bursting of the housing bubble has led to large losses for anyone who bought assets backed by mortgage payments; these losses have left many financial institutions with too much debt and too little capital to provide credit the economy needs; troubled financial institutions have tried to meet their debts and increase their capital by selling assets, but this has driven down asset prices, reducing their capital even further…"

  (Paul Krugman, "Gordon Does Good", *New York Times*, October 13, 2008)

- **Deleveraging accelerated in September/October 2008**
- **Adverse feedback loop between financial system and global economy**

What were roots of crisis?

- Low interest rates and economic growth led to returns being sought further down "credit-quality" curve, and over-optimistic assessment of risks
- Financial instruments developed offering higher yields, that were in fact very risky
- Market discipline failed – due diligence depended on credit-rating agencies, and compensation system in financial sector reinforced risk-taking

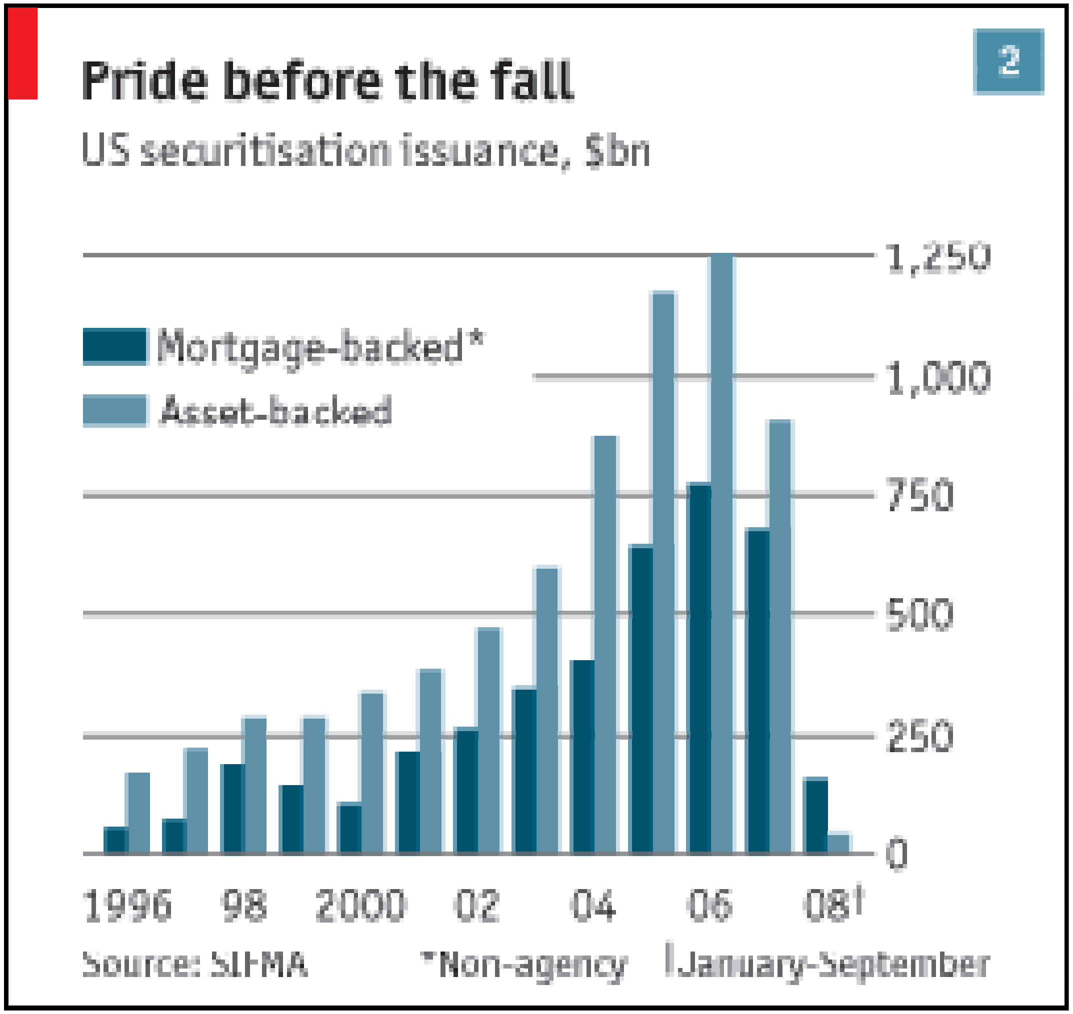
Planet finance.....

- **By end of 1990s subprime and prime mortgages sold on to banks, who *securitized* them**
- **Banks repackaged them as part of collateralized debt obligations (CDOs)**
- **Mortgage lenders who knew most about risk of default on subprime borrowers bore least risk:**

"...They could make a 'NINJA' loan and sell it on the same day to one of the big banks in the CDO business. In no time at all, the risk was floating up a fjord..."

(Niall Ferguson, "The Ascent of Money", 2008)

Planet finance…..



(*The Economist,* **January 22, 2009**)

Planet finance.....

- In 2006, $0.5 trillion worth of CDOs sold, of which half had exposure to subprime mortgages
- Many CDOs over-priced due to poor estimates of default risk on subprime mortgages
- July 2007, credit-rating agencies began to down-grade CDOs containing securitized mortgages – generating huge losses in system
- Banks disguised exposure by parking subprime-related assets off balance sheets in entities such as strategic investment vehicles (SIVs)

What were key policy failures?

- <u>Financial Regulation</u> – system not equipped to see concentration of risk and flawed incentives behind financial boom
- <u>Macroeconomic Policies</u> – no account taken of extent of systemic risks in financial system and housing market
- <u>Global Regulatory System</u> – fragmented surveillance of system with limited collaboration among national financial regulators

What has been learned?

- **Financial Regulation** – need to mitigate pro-cyclical effects, increase transparency about nature and location of risks, and facilitate liquidity management
- **Macroeconomic Policies** – should account for asset price movements, credit booms, leverage and build up of systemic risk
- **Global Regulatory System** – strong case for international cooperation

What are current priorities?

- **Immediate priority is reduction of uncertainty:**

  (i) Deal with "toxic" assets on balance sheets

  (ii) Do whatever it takes to avoid a deflationary spiral be it through fiscal measures or quantitative easing of the money supply by the Federal Reserve

- **Longer-term priority is to take regulatory action in financial sector to mitigate future crises**

Financial regulation: solution 1

- **Problem**: shadow-banking lightly regulated, and banks avoided capital requirements by pushing risk to affiliates in shadow system
- **Result**: shadow system became “too large to fail”
- **Solution**: regulation should be extended to broader financial system – objective being to determine systemic risk

  Oversight should stress longer-term horizons, strong governance, and process of risk management

Financial regulation: solution 2

- **Problem:** lack of due diligence in assessing risk in run-up to crisis
- **Result:** professional investors did not carefully examine type of assets they were buying, relying too much on credit-rating agencies
- **Solution:** reduce conflict of interest at credit-rating agencies and encourage better risk management

  Discourage mega-institutions via capital ratios that increase with leverage/contribution to systemic risk

Financial regulation: solution 3

- **Problem**: financial firm incentives based on generation of annual profits
- **Result**: ahead of crisis, large payouts to traders and managers based on increased leverage and risk, but did not face losses in downturn
- **Solution**: compensation schemes need to be added to overall view of risk-management and governance, and delinked from annual results and short-term indicators

Financial regulation: solution 4

- **<u>Problem</u>: mark to market accounting and excessive leverage**
- **<u>Result</u>: in upswing, rising asset prices raised banks' net worth encouraging excessive leverage, reverse is happening in downswing with excessive deleveraging**
- **<u>Solution</u>: need to make clear nature of asset price uncertainty, focusing on variance around fair-value calculations and data on price history**

Financial regulation: solution 5

- **<u>Problem/Result</u>: information gaps concerning:**

  (i) on-balance sheet risk of complex financial instruments, and off-balance sheet exposure

  (ii) counter-party risk in over-the-counter instruments

  (iii) degree of leverage and risk in shadow-banking

- **<u>Solution</u>: greater market transparency about valuation of complex financial instruments, allowing due diligence by investors**

Don’t ignore macroeconomics

- Global imbalances after Asian financial crisis
- Recycled money from high-saving countries, e.g., China, helped fuel US/UK asset price bubble
- Central banks focused on inflation, but did not see growing risks in their financial sectors
- Policymakers need to pay attention to asset price booms, excessive leverage and systemic risk
- Need measures to reduce systemic risk from large capital inflows, e.g., constraints on foreign exchange exposure of financial institutions