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ESMT Open Lecture with Avinash Persaud

What has caused the financial crisis and what hasn't?"
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Avinash Persaud is Chairman, Intelligence Capital Limited; Chairman, Warwick Commission, Member of the UN Commission of Experts (chair of its regulatory sub-committee) and Member of the Pew Congressional Task Force on Regulatory Reform. He is Emeritus Professor of Gresham College and Visiting Fellow, CFAP, Cambridge University. In 2000, he authored The Jacques de Larosiere Prize Essay on "Sending the herd off the cliff edge" on how some regulatory practices can increase systemic fragility.

The crisis which began in the US sub-prime mortgage market in early 2007 and then spread broadly and deeply was not the first banking crisis. It was closer to the 100th. We can draw a few important implications from this observation. If an event with widespread and severe economic and social consequences keeps on repeating itself, the onus is surely on the authorities to change something. Chiding bankers is satisfying; but insufficient. When a regulatory mechanism has failed to mitigate boom/bust cycles, simply reinforcing its basic structure is not likely to be a successful strategy. Moreover, a type of crisis that repeats itself cannot easily be put down to new, complex, instruments. We must set our sights on moderating the recurring cycle of financial crises, cycles that in our view are not wedded to particular instruments, institutions, individuals or information.

The prevention of crises in the banking system is more important than in the case of other industries. The externalities from an individual bank failure both to other banks and thence to the wider economy are just so much greater. One of the key purposes of bank regulation is to internalize the social costs of potential bank failures via capital adequacy requirements. The regulation of banks must do more than instil best practice amongst bankers, or converge regulatory capital to the capital a prudential bank would otherwise hold. The current approach to systemic regulation implicitly assumes that we can make the system as a whole safe by simply trying to make sure that individual banks are safe. This sounds like a truism, but in practice it represents a fallacy of composition. In trying to make themselves safer, banks, and other highly leveraged financial intermediaries, can behave in a way that collectively undermines the system. Selling an asset when the price of risk increases, is a prudent response from the perspective of an individual bank. But if many banks act in this way, the asset price will collapse, forcing institutions to take yet further steps to rectify the situation. It is, in part, the responses of the banks themselves to such pressures that leads to generalised declines in asset prices, and enhanced correlations and volatility in asset markets. Such endogeneity of risk is greater the more there is a common driver of behaviour.

Financial crashes do not occur randomly, but generally follow booms. Through a number of avenues, some regulatory, some not, though often in the name of risk-sensitivity, sophistication and modernity, the role of current market prices on behaviour has intensified. These avenues include mark-to-market valuation of assets; regulatory approved market-based measures of risk, such as credit default swap spreads in internal credit models or price volatility in market risk models; and the increasing use of credit ratings, which tend to be correlated, directionally at least, with market prices. In the up-phase of the economic cycle, price-based measures of asset values rise, price-based measures of risk fall and competition to grow bank profits increases. Market discipline encourages financial institutions to respond to these three related developments by some combination of (i) expanding their balance sheets to take advantage of the fixed costs of banking franchises and regulation (ii) trying to lower the cost of funding by using short-term funding from the money markets and (iii) increasing leverage. Those that do not do so are seen as underutilizing their equity and are punished by the stock markets. When the boom ends, and asset prices fall and short-term funding to institutions with impaired and uncertain assets or high leverage dries up, leading to forced sales of assets which drives up their measured risk, the boom turns to bust.

We distinguish between micro and macro-prudential regulation. Micro prudential regulation concerns itself with factors that affect the stability of individual institutions. Macro-prudential regulation concerns itself with factors that affect the stability of the financial system as a whole. The nature of the regulation applied to an individual

financial institution depends crucially on how "systemic" its activities are. This in turn is related, inter alia, to its size, degree of leverage and interconnectedness with the rest of the system. A critical component of macro-prudential regulation must be to act as a countervailing force to the natural decline in measured risks in a boom and the subsequent rise in measured risks in the subsequent collapse. This countervailing force has to be as much rule based as possible. Supervisors have plenty of discretion, but their ability to utilize it is limited by the general short-sighted desire to prolong a boom and by bankers pleading for equality of treatment. In a boom, lending, leverage and reliance on short-term liquidity become mutually reinforcing and excessive. To counter this we propose counter-cyclical capital charges. Regulators should increase the existing capital adequacy requirements (based on an assessment of inherent risks) by two multiples. The first is related to above average growth of credit expansion and leverage. Regulators should agree on the degree of bank asset growth and leverage that is consistent with the long-run target for nominal GDP, so that the multiple on capital charges rises the more credit expansion exceeds this target. The purpose of this capital charge is not to eliminate the economic cycle – something which would be unrealistically ambitious - but to ensure that in a boom, when risk measures are suggesting banks can safely leverage or lend more, banks are putting aside an increasing amount of capital which can then be released when the boom ends and asset prices fall back.

The second multiple on capital charges should be related to the mis-match in the maturity of assets and liabilities. One of the significant lessons of the Crash of 2007/8 is that the risk of an asset is largely determined by the maturity of its funding. Our proposed adjustment to mark-to-market accounting should provide a further incentive to reduce maturity mismatch. Northern Rock and other casualties of the crash might well have survived with the same assets, if the average maturity of their funding had been longer. When regulators make little distinction how assets are funded, there is a tendency for financial institutions to rely on cheaper, short-term funding, which increases systemic fragility. If short-term funding of long-term assets carries a capital cost – because it weighs on systemic stability – it will moderate banks' reliance on systemically adverse short-term funding and encourage them to seek longer-term funding.

A combination of these charges should push banks to develop incentive packages that are more encouraging of longer-term behaviour, More is required on this front, though we do not share the zeal of some for governments to be involved in the micro-decisions of private firms.

There is a tendency, commonly observed amongst politicians, to review the structure of the regulatory system before considering the potential instruments to achieve better regulatory control. Our position, is the reverse. The structure of regulation should reflect the purposes and powers of the regulatory authorities. Macro-prudential, and micro-prudential, instruments are both needed, but differ in focus and in their needed professionalism. Hence, they should be carried out separately, respectively by Central Banks and by Financial Services Authorities. Again, financial and asset-price cycles differ from country to country. So contra-cyclical policy needs to be assumed more by the host country, thereby shifting some of the emphasis in regulation from the home to the host country. Despite all the talk on global regulation, the real efforts will be national, or in the case of Europe - regional.

(Prof) Avinash D. Persaud

Chairman, Intelligence Capital Limited
Chairman, Warwick Commission,
Member, UN Commission of Experts,

avinash@intelligence-capital.com