‘Wasting the Crisis:’ The G-20’s Role in Financial Sector Reform

By Richard Portes

SUBHEAD
At the height of the recent financial crisis, the Group of 20 nations appeared to be leading the charge to reform the global financial sector to prevent a repeat of the meltdown that threatened the world economy. But two years after a lofty declaration by the G-20 promoting reform, the picture is decidedly mixed, writes London Business School economist Richard Portes.

In the winter of 2008-09, after the collapse of Lehman Brothers, there seemed a serious prospect of extensive financial sector reform. The deregulation of the previous two decades had led to a costly debacle. The G-20 summit declaration of Nov. 15, 2008 proposed an apparently ambitious program of reforms. In the declaration’s words:

• We will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises … Our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards … and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments … Regulators must ensure their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage…
• The IMF, expanded FSF and other regulators and bodies should develop recommendations to mitigate pro-cyclicality, including reviewing how valuation and leverage, bank capital, executive compensation and provisioning practices may exacerbate cyclical trends …
• National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to ensure they permit an orderly wind-down of large, complex, cross-border financial institutions…
• Regulators should take steps to ensure that credit rating agencies … avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products …
• Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency…
• Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of, and central bank liquidity operations for, cross-border banks…Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions…
• Financial institutions should have clear internal incentives to promote stability, and action needs to be taken, through voluntary effort or regulatory action, to avoid compensation schemes which reward excessive short-term returns or risk taking…
The reforms that were stipulated in the G-20’s declaration, seen in light of the assertion that “financial markets are global in scope,” were directed primarily towards regulators in the context of existing legislation and regulatory structures. But it was clear in both the United States and the European Union that major, far-reaching new legislation was required to remedy the institutional defects that the crisis had exposed. Academic studies also made concrete proposals to the G-20 on these issues (e.g. Dewatripont et al., 2009).

Almost two years later, the achievements do not measure up to the ambitions. In this sense, we have “wasted the crisis.” Supported hugely by public funds, the banks that seemed to have been brought to the ground quickly rose and began a massive lobbying effort to limit any regulatory threat to their profitability. Benefiting from exceptionally low interest rates, their earnings recovered and were used to restore the bankers’ bonuses rather than their capital bases. The consolidation of the banking sector left those still standing even more powerful economically and politically. In the US, the Dodd-Frank comprehensive “regulatory reform” bill that was passed in July 2010 was somewhat stronger than had been expected a few months before, perhaps because of public anger at revelations of misbehavior by Goldman Sachs. But it will not forestall a new, essentially similar crisis a few years down the road. The EU has also passed new legislation, and more is forthcoming, but it too is likely to be deeply inadequate.

There will always be financial crises. That is in the nature of a dynamic, innovative capitalist economy with a relatively unconstrained financial system. The best we can hope for is that the next crisis will be different, that measures taken in response to the current crisis will block the mechanisms that gave rise to it and mitigate the consequences of the next major disturbance. That was, in fact, the result of the Great Depression — a new framework of financial regulation that underpinned considerable stability for 75 years. The major financial shocks of 1987 (the stock market crash), 1992-93 (the breakdown of the European exchange-rate mechanism), and 1997-1998 (Asia, Russia, Long-Term Capital Management, foreign exchange markets) had no significant impact on the real economy.

What, then, has been accomplished from this latest crisis? What has been the practical effect of the international co-operation mandated by the G-20 declaration? What can the G-20 now ask of its members on financial regulatory reform?

One area of cooperation appealed greatly to politicians: shut down tax havens and be tougher on money laundering. Never mind that this was essentially irrelevant to the crisis, and such measures could have been implemented long ago — suddenly they became a priority, and indeed this effort seems to have been quite effective. Clearly, international cooperation was essential here, and it was finally forthcoming as an outcome of the crisis. Next on the political list, particularly in Europe, was regulation of hedge funds and private equity. Again, there is little evidence that either played any significant role in the crisis. Nevertheless, they have commanded considerable attention from the European Parliament and the European Commission, and EU member-state finance ministers have spent long hours negotiating a new regulatory regime for these institutions. The result (the Alternative Investment Fund Managers directive) is still crude and somewhat protectionist, but more important, it is a distraction from the key issues: what to do about the banks, macro-prudential regulation, dysfunctional markets, the ratings agencies and cross-border conflicts.
No Real Teeth

Bankers’ bonuses, and more broadly their incentive structures, have drawn considerable attention. It is not clear, however, that any new regulations specifically governing compensation would curb dangerous risk-taking and instill long-term incentives. Bear Stearns and Lehman Brothers employees had much of their personal wealth invested in their firms’ equity, but this “skin in the game” did not seem to have had any effect. The UK’s tax on bank bonuses brought in revenue, but seems to have had little effect on compensation. The Dodd-Frank bill does nothing more than give shareholders a non-binding vote on executive pay.

More important is the extraordinary overall widening of income differentials in favor of the financial sector that accompanied deregulation (see Philippon and Reshef, 2009). Highly regulated banking had been a rather conservative occupation, with correspondingly reasonable rewards, which did not attract “the best and the brightest.” As regulation relaxed, considerable intelligence and imagination went into “financial innovation,” with disastrous results. Specific caps on compensation or taxes on bonuses will be ignored or avoided in the competition for “star talent.” What is necessary is to eliminate the excessive profits and rents that oligopolistic, opaque and unconstrained banks can and do earn. One remedy is to break up the big banks (Johnson and Kwak, 2010), another is much deeper cross-border cooperation to limit regulatory arbitrage — both of which are discussed in more detail below.

The banking sectors in the US and the UK, in particular, but also in several other advanced countries, were already highly concentrated before the crisis. Several major banks have absorbed competitors in the past three years. Many are now not only too big to fail, but also in some cases too big to rescue (in Iceland, as we saw, Switzerland, possibly Ireland and perhaps even the UK). They may even be too big to regulate or manage effectively. The six largest financial firms in the US have $9.5 trillion in assets. Fifteen years ago, no bank had anywhere near $1 trillion. Four banks, of which two are now partly nationalized, dominate the UK financial landscape.

Size creates massive barriers to entry. And it is not demonstrably conducive to efficiency — most of the academic literature suggests that above assets of $50 billion-100 billion, there are few observable economies of scale or scope.

It might have been the separation between commercial and investment banking enforced by the Glass-Steagall Act of 1933 — which was repealed in 1999 — that limited the effects of financial disturbances on the real economy. But the Dodd-Frank bill did not restore Glass-Steagall. The so-called “Volcker Rule,” which restricts banks from engaging in certain kinds of speculative investments, does force some separation of proprietary trading from banking, and some of the investment banks are already establishing separate trading subsidiaries. But proprietary trading was not a significant factor in the crisis, nor will the separation mitigate the “too big” phenomenon.

Handling Size

If the systemically important institutions are too big to fail, the appropriate response might be to break them up. Without new legislative authority, this could proceed on the grounds of competition policy. But the competition authorities in the US, the UK and even the more aggressive European Commission seem to have little appetite for this. There is a well-justified fear of regulatory arbitrage, too: the big UK banks have already
threatened they would move their headquarters abroad were the new UK Commission on Banking to recommend any significant downsizing or dismemberment. Here the G-20 could play a role, if it could agree to a common policy that no member state would accept such a move. But it is hard to see some key jurisdictions outside the G-20, such as Switzerland, Hong Kong and Singapore, accepting such a policy.

A so-called Tobin Tax on financial transactions — an idea proposed by Nobel Laureate James Tobin — would have no effect on bank size, even if it could be agreed and implemented effectively (both unlikely). A tax based on size of assets, or capital adequacy ratios that rise with size, could work. But neither is likely, especially as this would require legislation, and the US is unlikely to go further than Dodd-Frank in the foreseeable future.

An alternative way of dealing with size is to design effective resolution regimes for systemically important institutions. But it would be extremely difficult to implement a resolution in crisis conditions. There is some support for “living wills,” in which each big bank would set out ex ante detailed proposals for resolving insolvency that regulators would agree on with the bank. But doing this properly for cross-border institutions would require national authorities to agree in advance on how the fiscal burden of insolvency would be shared. There is great resistance to any such burden-sharing arrangements — for example, the European Central Bank has opposed them on the grounds that they would create moral hazard, and national governments are in any case unwilling to make such commitments of taxpayer funds.

Living wills might at least force the transformation of bank branches outside the headquarters country into separately capitalized subsidiaries. They might also bring about the unwinding of some of the complexities of bank structures, many of which are there for tax avoidance. Both consequences are desirable. The banks maintain that breaking them up, downsizing them or requiring such restructuring would limit their global intermediation capacity. There is no evidence for this, in view of their capacity to act cooperatively in many areas, such as underwriting and mergers and acquisitions.

Various proposals for “contingent capital” are also now being discussion in the run-up to the G-20 summit in Seoul. These are essentially securities that would lose everything or be converted into equity if some kind of trigger were detonated before insolvency (e.g., a minimum capital ratio or a bailout). But there are cogent arguments that these could prove destabilizing.

Cross-border cooperation would have been essential to deal with the too-big issue, but the G-20 has not provided it. Through its Financial Stability Board and the Basel Committee, it seems to have made some progress on macro-prudential regulation. The banks had protested that higher capital requirements would severely restrict their lending and hence investment and growth in the real economy, but the Bank for International Settlements (BIS) has comprehensively refuted these exaggerated claims, and in September the Basel Committee agreed new capital requirements. There will be an increase in capital adequacy ratios, but the reforms did not go nearly as far as many had expected — the new ratios are much lower than banks carried as a matter of course a couple of decades ago — and the transition period will be long.

Before 2004, Wall Street firms were limited to leverage ratios of 12. Then the five largest banks obtained waivers, and leverage rose dramatically — as it did in the UK, Germany and elsewhere. Dodd-Frank does not address leverage, but Basel has done so.
Thinking Counter-Cyclically
True macro-prudential regulation would make capital ratios, liquidity ratios, leverage and mortgage loan-to-value ratios vary counter-cyclically. Central banks have complained that they have only one instrument, interest-rate policy, which they use to achieve their inflation targets, and they cannot use it also to maintain financial stability. Macro-prudential regulation would be the second instrument. It is not at all clear that it will be developed and used effectively, despite the G-20 injunction to “mitigate pro-cyclicality.” Note that since business cycles are still characteristics of national economies, the host regulator would have to rule in counter-cyclical regulation, and this too would bring pressure on cross-border institutions to go from branches to subsidiaries.

Regulatory structures are being developed to deal with systemic financial stability. Dodd-Frank provides for a new Financial Stability Oversight Council, and the EU will have a new European Systemic Risk Board. The former will have a manageable 10 members; the latter will be several times that size and will almost certainly be unmanageable. The EU will also have three new European Supervision Authorities — for markets, banks and insurance companies — essentially giving somewhat enhanced powers to the existing committees of regulators. It is hard to see any significant progress here.

Securities markets, of course, are now totally global. But regulatory authority over them is not, and the G-20 has made little progress in this respect. In the US, the Commodities and Futures Modernization Act of 2000 blocked any regulation of derivatives markets, and other jurisdictions had to follow. Dodd-Frank did not abolish the CFMA, but it will bring some reversal. Regulators are enjoined to require a move to central counterparties (CCPs) for over-the-counter derivatives. But this was supposed to have happened long ago, and the banks have fought effectively to slow it down.

There was an effort to force them to hive off derivatives trading, but the “Lincoln amendment” to achieve this was watered down. Banks can keep their business in derivatives involving interest rate and foreign exchange swaps, as well as credit default swaps (CDS) on investment-grade entities. However, derivatives on commodities, equities and below-investment-grade CDS must go into separately capitalized subsidiaries. There will be some pressure to require exchange trading of current OTC derivatives, but the opacity and specificity of these contracts is so profitable to the banks that they will fight in the trenches against this. They claim that CCPs will require excessive, expensive collateral, while exchange trading would make it impossible to tailor instruments to the precise hedging needs of clients. Both will destroy liquidity, they say. The correct rejoinder is that any such costs are reasonable in view of the systemic dangers of the OTC markets (as was seen in the case of AIG’s collapse in 2008). In particular, market liquidity is not an end in itself. It seems unlikely, however, that the G-20 will have any impact here.

Financial innovation is beloved of finance professors and finance professionals. It has been enormously profitable — but also, demonstrably dangerous. Collateralized debt obligations (CDOs), their related spin-offs and “naked” credit default swaps contributed importantly to the crisis. “Market completeness” is not an end in itself; nor is the financial innovation that supposedly promotes it. There is a good case for banning some of these financial instruments (Portes, 2010). New proposals from the European
Commission include some moves in this direction, but not enough to make a difference, especially if the US does not follow.

Failure Zone: Ratings Agencies
The multiple failures of the ratings agencies were also a major cause of the crisis. The G-20 agreed that they should be regulated. And indeed, the European Securities and Markets Authority will do so, as will the new US Securities and Exchange Commission’s Office of Credit Ratings, created by Dodd-Frank. But the proposed regulatory authority is unlikely to have any significant effect. Yes, ratings will be separated from the very profitable “advisory” services ratings agencies provide, telling issuers how to structure securities to obtain a good rating. But there will be no required changes to the “issuer pays” funding model, nor any provisions that will limit “ratings shopping.” Monitoring the agencies and the models they use will have little impact (Portes, 2008). This industry is an extreme oligopoly, in which three firms control 95 percent of the business. The oligopoly is reinforced by the “regulatory license” (Partnoy 2006) that embeds ratings in a wide range of regulations (e.g., requiring that investment funds hold only “investment grade” securities). The regulators have, in effect, outsourced their responsibilities for evaluating the level of risk in institutional portfolios, while eliminating the need for institutions to do their own due diligence. The Financial Stability Board is currently studying in detail how the ratings are “hard-wired” into the regulatory system, and eventually we may see some progress here. That would be an achievement for the G-20.

The G-20 raised hopes for coordinated, global action on regulatory reform. Despite the efforts of the FSB and the Basel Committee, the US Congress and the EU authorities, the concrete results have been very limited. The banking lobby has proved very powerful. Perhaps there is also just too much competition among jurisdictions (especially the US and the EU) and financial centers — in particular, New York, London, Paris, Frankfurt and Zurich. The fear of regulatory arbitrage is justified, and that should be the main motive for cooperation. But the advanced country financial centers also look over their shoulders at potential emerging market competitors. Here the G-20 has failed, insofar as the emerging market countries feel under-represented in the regulatory discussions, and this makes them less likely to cooperate, and more likely to be the beneficiaries of regulatory arbitrage.

The G-20 has many other important issues on its agenda for November. It seems very unlikely that the summit in Seoul will make any progress on financial regulatory reform beyond ratifying and commending what has already been done — and that is far too little. So we do seem to be “wasting the crisis.”

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References
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