Banking Regulatory Reform: new challenges

Abel M Mateus

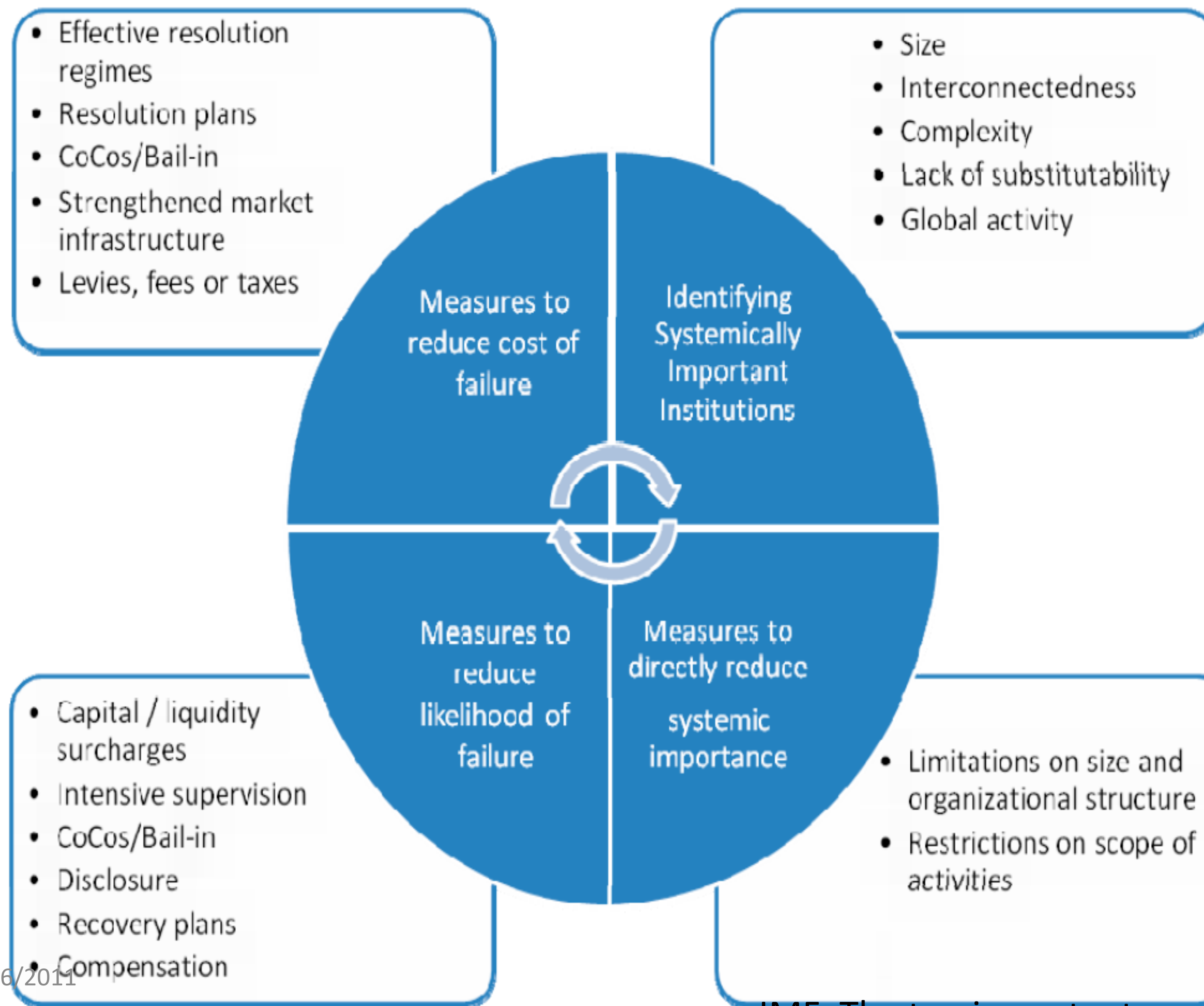
New University of Lisbon

London University College, June 8th, 2011

Outline

- Systemic risk and current response to regulation after the crisis (huge moral-hazard problem)
- Vicker´s Report: too big to fail and conflicts of interest depository v. investment institutions
- Missing micro-regulation and reform of shadow-banking
- Governance reform
- Some competition issues

Dealing with the Risks Posed by Systemically Important Financial Institutions Beyond Basel III

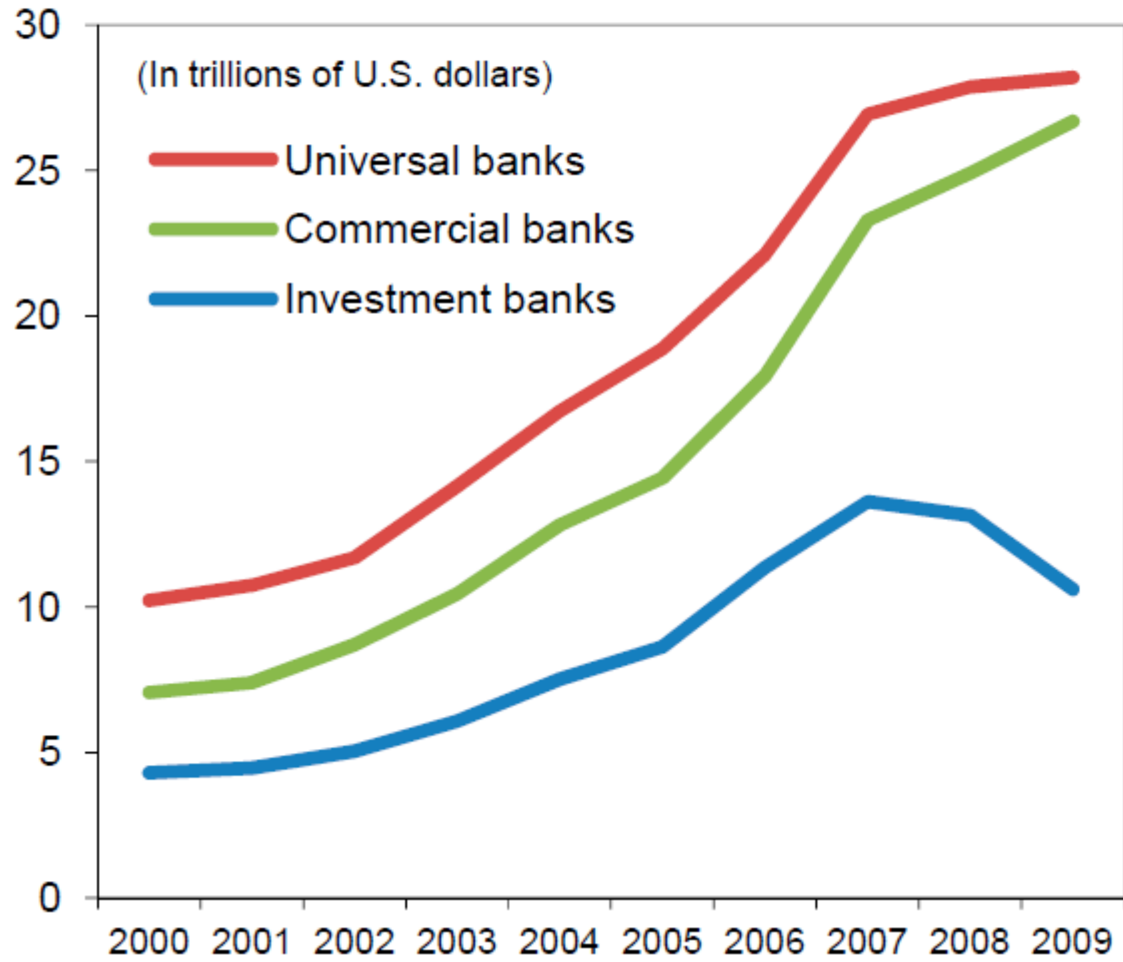


IMF, The too important conondrum, 2011

Implicit advantages of big institutions

- Despite the added risks they pose to financial stability, compared with systemically less important institutions, their implicit or explicit government backing gives them a funding advantage and, therefore, a competitive advantage
- Given their size and importance to their domestic economies, these institutions may enjoy strong political ties and hence may be in a position to influence regulatory policies to their advantage (regulatory capture)
- Over the past decade, the institutions that could be considered as potentially systemic doubled their market share
- Logit analysis shows that it is higher the probability of a rescue the higher is the share of the bank´s assets to GDP and higher the interconnectedness (and if it is a retail-oriented bank)

Big institutions continue to increase market share, even after the crisis



Response to Current Regulation

- Systemic risk has not yet been properly evaluated
  - Brunnermeister CoVar
  - Duffie 10by10by10
  - Still has to be translated into stress tests
- Risk of each institution considered in isolation: Value at Risk
- Capital requirements are still procyclical; Basel III still relies heavily in internal models (IRB)
- Problem of ratings has not been solved: self-assessment is no option; rating agencies based on issuer pay
- Focus on asset side of the balance sheet
- Differential capital treatment across industries
  - *Response* to current regulation: "take positions that drag others down when you are in trouble" (maximize bailout probability)
  - become big, interconnected, hold similar positions

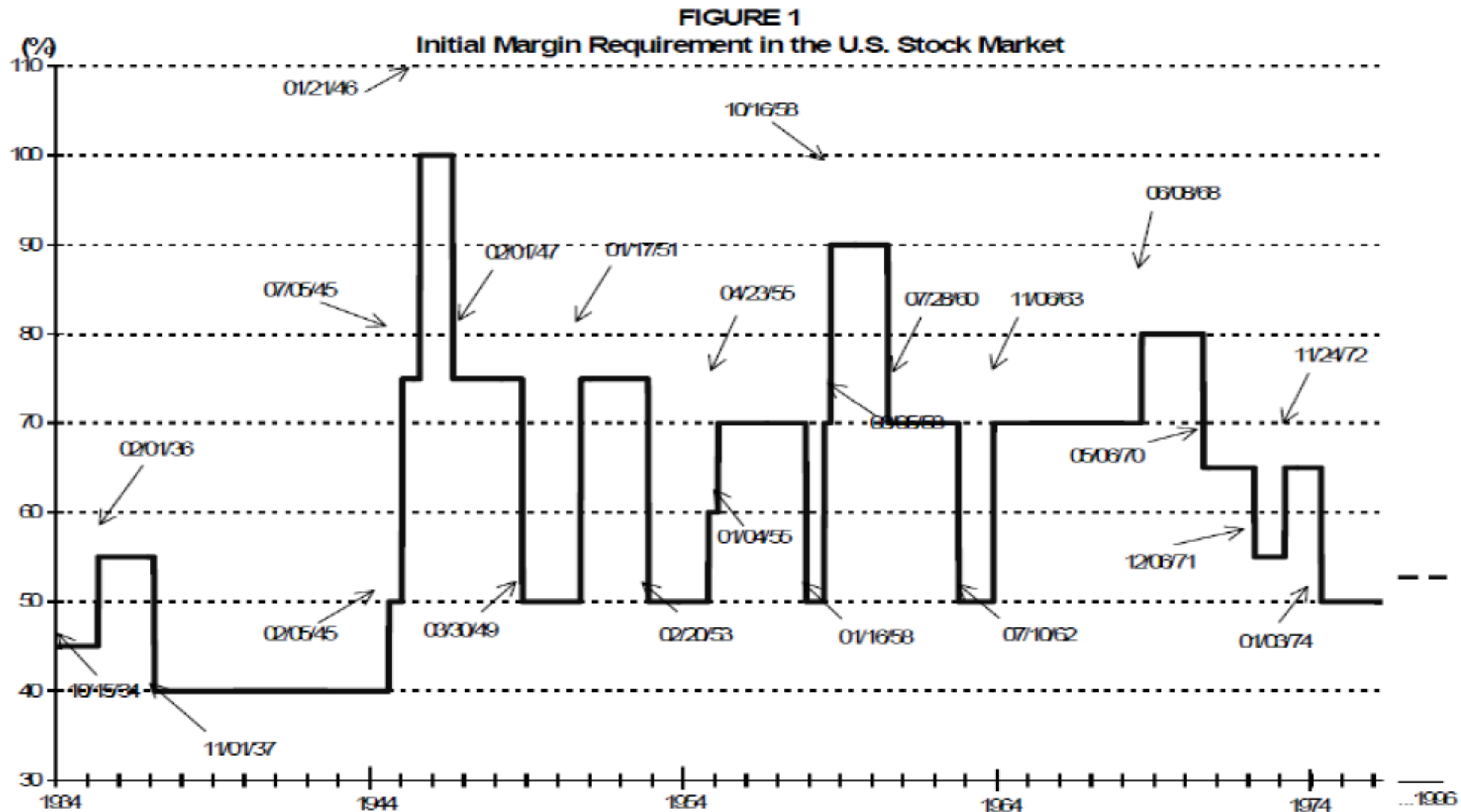
Need new type of regulation

- Focus on externalities –systemic risk contribution
  - Internalize externalities (… just like pollution)
  - Fire-code analogy: fire-protection wall
  - CoVaRi= VaR system|i in distress
- Countercyclical regulation
  - Regulate based on characteristics that give rise to *future* systemic risk contributions
- Incorporate funding structure
  - asset-liability interaction, debt maturity, liquidity risk
- Objective regulatory criteria across financial institutions
  - Banks, broker-dealers, insurance companies, hedge funds,…
- ….Bankruptcy procedure, living will, …. (Geneva Report)

Macro-regulation

- Problem of weights of risky assets
  - Public securities have a zero weight for OECD countries! When several states are in debt unsustainable paths
  - Covered-bonds have a low weight (20%) for under-writer
  - Problems of VARs and Internal models: self-regulation and self-assessment of risk!
- Problem of asset-bubbles
  - Current proposal: increase BIS III ratios
  - Complementary proposal: increase margins and capital requirements in shadow-banking

- The Fed decided the initial margins in US stock market, which kept unchanged since 1974.



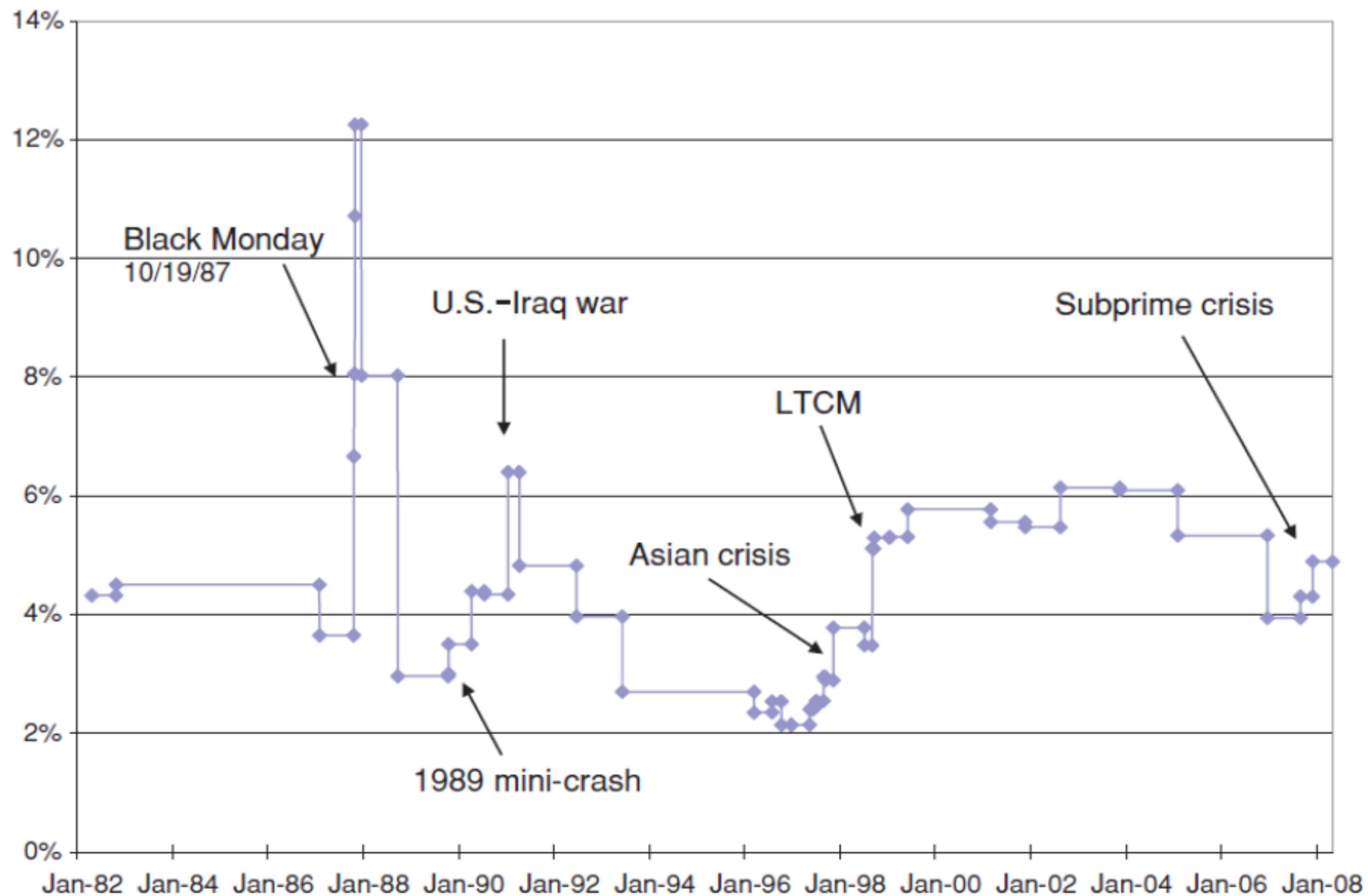


Figure 1
Margins for S&P 500 futures
The figure shows margin requirements on S&P 500 futures for members of the Chicago Mercantile Exchange as a fraction of the value of the underlying S&P 500 index multiplied by the size of the contract. (Initial or maintenance margins are the same for members.) Each dot represents a change in the dollar margin.

Macro- vs. Micro-prudential regulation

- **Fallacy of the Composition:**
  what's micro-prudent need not be macro-prudent

Balance sheet	action	micro-prudent	macro-prudent
Asset side	(fire) sell assets	Yes	Not feasible in the aggregate
	no new loans/assets	Yes	Forces others to fire-sell + credit crunch
Liability side	(raise long-term debt)		
	raise equity	Yes	Yes

- Micro: based on risk in isolation
- Macro: Classification on systemic risk contribution measure, e.g. CoVaR
- Ratios versus Dollars

Source: Brunnermeier, Berlin Finance Lecture, 2010

Who should be regulated?

group	examples	micro-prudential	macro-prudential
"individually systemic"	International banks (national champions)	Yes	Yes
"systemic as part of a herd"	Leveraged hedge funds	No	Yes
non-systemic large	Pension funds	Yes	No
"tinies"	unlevered	No	No

Source: Brunnermeier, Berlin Finance Lecture, 2010

Depository and investment separation: Vickers compared

- Vickers: ring-fence retail banking businesses from wholesale/ investment banking activities through firewalls in a banking group
  - May be the best alternative, but needs to be complemented with other measures
  - Should it be exported to the EU?
- Separate commercial and investment banking, as under the U.S. Glass-Steagall Act of 1933
- Volcker Rule that restricts (with exceptions) banks' proprietary trading and investment in, or sponsorship of, hedge and private equity funds
- U.S. Swap Pushout Rule that requires certain entities relying on federal assistance and with significant swap business to move such activity to separately capitalized nonbank affiliates

Main questions for debate

- In the Crisis of 2007-9, problems arose in investment (shadow) banking and spread to retail banking: investment banks transformed themselves into BHC in order to have access to FED funding
- How to implement in practice the borderline between activities and create stand-alone entities, avoid cross-funding and funds transfer
  - To protect a bank holding company to seek riskier assets to compensate for higher capital requirements it is necessary to have rules on what bets a retail subsidiary can make – to prevent it ultimately behaving like an investment bank in retail clothing
  - Lehman´s failure, an investment bank, led to a major increase in overall systemic risk (spread-out thru retail banking)
- Technicalities: bail-in mechanisms, contingent capital and subordinating the claims of other senior unsecured creditors to those of depositors
- The Basel III risk-weighting system, as the Commission acknowledges, is fundamentally flawed and vulnerable to gaming by the banks
- Provided universal banks maintain minimum capital ratios and loss-absorbing debt for their UK retail operations, capital could be switched from the UK retail subsidiaries to other banking activities
- Lack of robust cross-border resolution mechanisms
- Mute on supervision issues
- Mute on incentive mechanisms: bank executives pay remain substantially linked to the inappropriate metric of return on equity, which encourages them to increase leverage

Micro-regulation

- The origin of recent financial crisis was in the mortgage lending
- Need for regulatory measures
  - Limiting loan-to-value ratio (70 to 80%)
  - Real estate valuations done by independent appraisers (regulation of appraisal business has been neglected)

- Regulation of securitization (now moving into SMEs, consumer credits, etc.)
  - Originator-to-distribution model: originator needs to retain at least 10% of risk (mainly equity risk) [Frank-Dodd only 5%!]
  - Problem of ratings not yet solved
  - Slicing of packages should not dilute incentive to monitor and enforce lending
- Regulation of covered-bonds
  - New trend: but regulation still did not catch-up

The rise of shadow-banking

- Since in the 1970s, there has been a major shift in the source of transaction media away from demand deposits towards money-market-mutual funds (MMMFs). MMMFs reached a peak of $3.8 trillion in 2008. Money market funds are registered investment companies that are regulated by the Securities and Exchange Commission (SEC) in accordance with Rule 2a-7 adopted pursuant to the Investment Company Act of 1940.
- Securitization refers to the process by which traditionally illiquid loans are sold into the capital markets, by selling large portfolios of loans to special purpose vehicles (SPVs), legal entities that issue rated securities in the capital markets. Total non-agency ABS issuance reached $1.65 trillion in the eve of 2007.
- Large use of repos, as money under management by institutional investors (pension funds, mutual funds, states and municipalities, and nonfinancial firms) expanded. They handled as much assets as banks. Repo market at $5 trillion in US and $5 trillion in Europe (role of primary-dealers) and importance of haircuts.

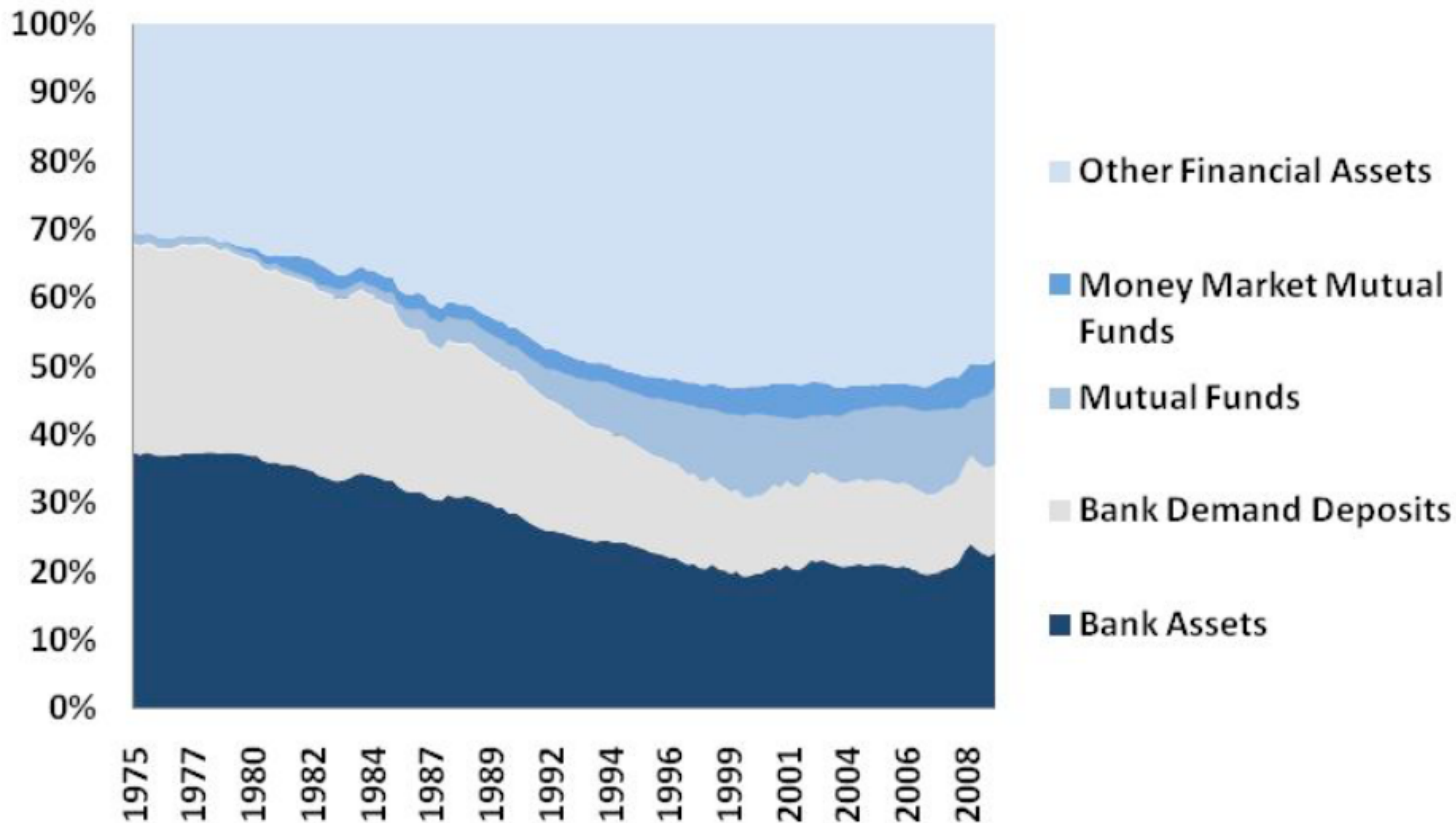


Figure 3: Money Market Mutual Funds, Mutual Funds, Demand Deposits, and Total Bank Assets as Percentages of Total Financial Assets
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
1975
1977
1980
1982
1984
1987
1989
1992
1994
1996
1999
2001
2004
2006
2008
Other Financial Assets
Money Market Mutual Funds
Mutual Funds
Bank Demand Deposits
Bank Assets

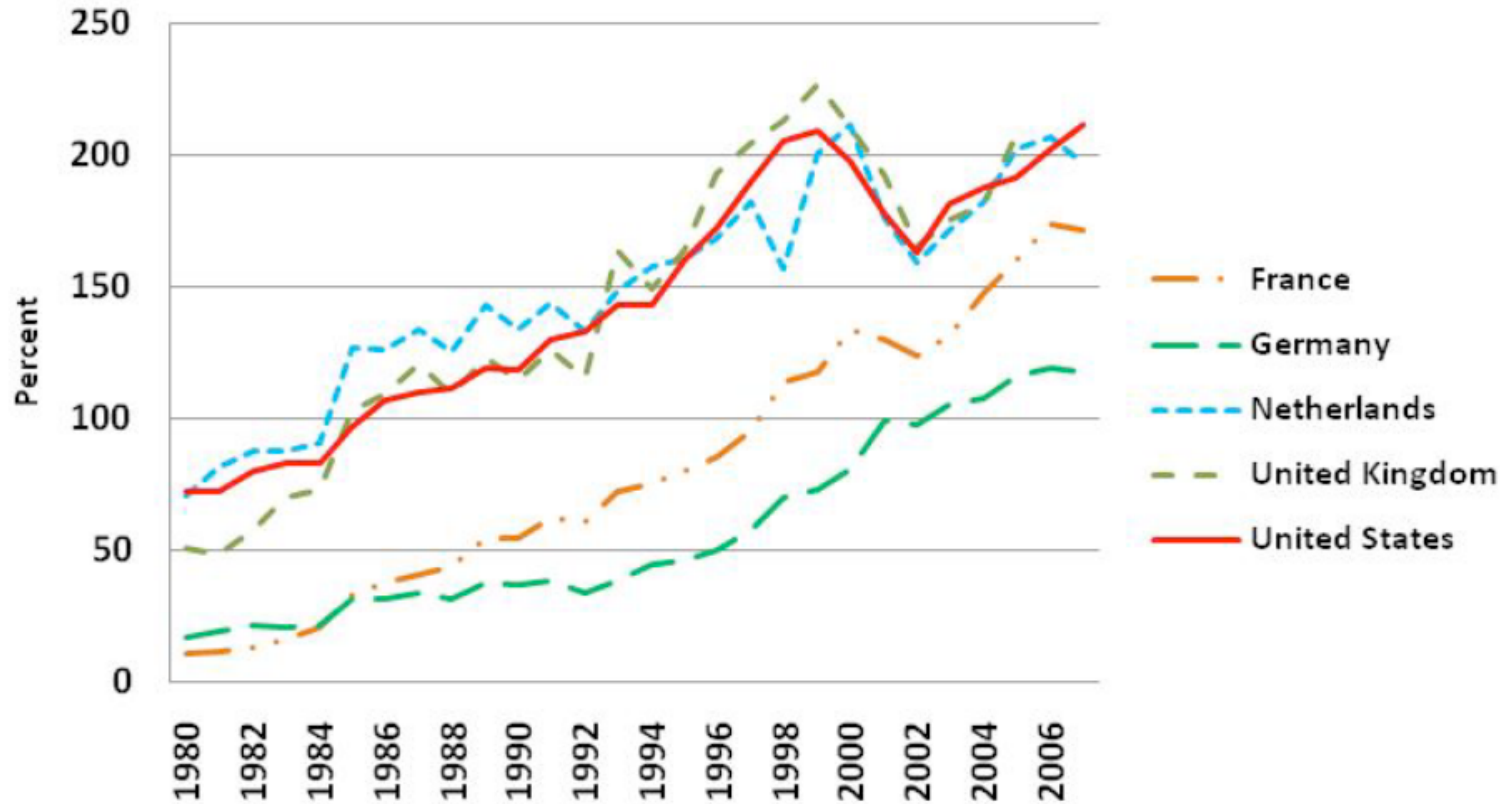


Figure 7: Financial Assets of Institutional Investors as a Percent of GDP
Percent
250
200
150
100
50
0
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
France
Germany
Netherlands
United Kingdom
United States

Huge risks in shadow-banking

Security	Typical haircuts	March 2008 haircuts
Treasuries	< 0.5%	0.25% ~ 3%
Corporate bonds	5%	10%
AAA ABS	3%	15%
AAA RMBS	2%	20%
AAA Jumbo Prime mortgages	5%	30%

Table 3. Haircuts during March 2008 compared to normal levels (Source: Bloomberg)

Reform of shadow banking regulation

- "Group of Thirty" (Group of Thirty, 2009) for the regulation of Money Market Mutual Funds having a choice of treatment as either
  - Type1:"Narrow Savings Banks" with a stable net asset values
  - Type 2: conservative investment funds with floating net asset values and no guaranteed return

  Under this system, type (1) funds are clearly within the safety net (explicit insurance), and type (2) funds are not
- Chartering of "Narrow-Funding Banks" as vehicles to control and monitor securitization, combined with regulatory oversight of acceptable collateral and minimum haircuts for repo

Governance Issues

- Regulator/Supervision authority
  - Accountable to whom? Government, Parliament?
  - Avoiding regulatory capture
  - Incentive schemes for regulators?
  - Transparency v. confidentiality (avoiding rumours/panics): publishing reports on failed institutions (what about troubled institutions: market discipline)
- Financial Institutions
  - Board nomination (controls on competence?)
  - Conflicts of interest (lender/shareholder)
  - Management fully responsible for troubled institution
  - Prompt court action in fraud cases
  - Transparency: reports content

Competition issues

- Need a EU rule of limit of 10% applied to the EU overall market
  - Although market shares are blunt instruments they establish bright lines that are easy to implement (Frank-Dodd Act has it after 100 years of antitrust)
- Methodologies for assessing bank mergers and intensity of competition are not yet well developed throughout EU Competition Authorities
- Easier ways to transfer accounts: SMEs history-passport
- Consumer protection is not enough: decreasing barriers to switch may entail additional regulation

THANK YOU

abelmateus001@gmail.com