The G20's Reform of Banking Regulation and the Changing Nature of the Global Financial System

Paper by Malcolm D Knight

Comments by William R White

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Introduction

Malcolm's paper essentially reviews the post-crisis changes made to the global regulatory structure under the general guidance of the G20 and the specific direction of the Financial Stability Board (FSB). The last few lines of Malcolm's paper present a concise summary of his conclusions.

"Policy makers should not be too confident that the G20's financial regulatory reform programme has made financial system–wide crises a thing of the past. There is still much to do to achieve a stable and resilient market based global financial system"

I totally agree with this conclusion. Indeed I wrote a paper, published in 2014, whose title conveyed the same message[1]. That said, I am actually significantly more negative than Malcolm about both the usefulness of what has been done, and about the likelihood that "still more of the same" regulation will significantly reduce the chance of further crises going forward.

After reviewing the justified concerns raised in Malcolm's paper, I will then add a few more personal sources of concern that he has not highlighted. Then I will ask "where to from here" and suggest some alternative reforms that might prove useful. Evidently, the more radical of these raises the likelihood of political pushback from those who profit from the current system. But reform has always to do as much with politics as economics.

Malcom Knight on the Global Financial Regulatory Agenda

Early in the paper, Malcolm notes that post crisis changes to micro prudential regulations have focused primarily on banks and in particular on G-SIBs. He assesses these changes positively. Indeed, he states that they "vastly strengthen the solvency, liquidity and risk management of banks". Almost immediately, however, he adds that the **G-SIBs** remain highly levered, and a potential source of trouble for institutions with which they remain highly connected. His ambivalence about the impact of recent regulatory changes seems to mirror that of the broader financial community. Broadly speaking,

[1] White W R (2014) "The prudential regulation of financial institutions: Why regulatory responses to the crisis might not prove sufficient" Economics Department Working Paper No. 1108, OECD, Paris

regulators view the glass as “half full” while industry representatives see it as “half empty”.[2]

To the concerns raised by Malcolm about the continuing dangers posed by G-SIBs might be added others. Larry Summers in a recent Brookings Paper looks at market based measures of the risk associated with the stocks of individual banks. He concludes that there is “no evidence that markets regard banks as safer today than they were prior to the crisis”. While leverage has been much reduced, this contribution to safety appears to have offset by reduction in the franchise value of these institutions. These reductions Summers then attributes almost entirely to policy measures, both regulatory and monetary. As for “living wills”, to which Malcom makes positive reference, my understanding is that the Fed has rejected virtually all of them as “unfit for purpose” This is not encouraging and indicates that the “Too big to fail” problem remains in the US. Dirk Schoenmaker[3] argues that serious problems remain in Europe as well.

If post crisis regulatory measures to strengthen G-SIBs have been inadequate, or in some cases even counterproductive, then we might can expect an ironic outcome over the longer term. Until the issue of how to resolve/wind down a G-SIB is adequately dealt with, G-SIBs regulated into unviability will have to be supported with taxpayer’s money. We will have shot ourselves in the foot. One can only hope that more recent measures to increase total loss absorbing capacities (TLAC) will prove adequate to avoid this outcome.

Malcom sees banks as “the core of the financial system” and, through their interlinkages and links with non-banks, banks are capable of both transmitting shocks to others and amplifying shocks with non-bank origins. Malcolm refers to these linkages as **interdependence** though he often uses the word “contagion” in a conflated way. This is unfortunate since Hal Scott in a recent book argues that the two things are very different. Interdependence implies that shocks spread endogenously and inevitably. In contrast, contagion is an exogenous force (a kind of panic) that may materialize or not. Scott underlines that, even were the interdependencies to be totally cut, contagion could still lead to systemic crises and the need for a lender-of-last-resort.

[2] I base this assertion on comments made at a number of panels I have chaired for Eurofi High level Seminars, which had both European and North American representation.

[3] Schoenmaker D (2016) “The impact of the legal and operational structures of euro area banks on their resolvability” Bruegel Institute, Policy Contribution Issue No 23.

While Malcolm notes that interdependence remains a problem, he might also have noted how little appetite there has been to attack the problem directly[4]. The down side of globalisation might be addressed by insisting that foreign banks act as subs and not branches. The down side of securitization might be addressed by reducing the increasingly dangerous role of financial collateral in the system. The down side of consolidation might be addressed by breaking up big banks, or by ring fencing retail from wholesale activities. In practice, concerns about "efficiency" have dominated the need for modularity and redundancy to keep the financial system safe.

Another issue related to interdependence and financial stability is noted only in passing by Malcolm, but it deserves far more attention. Financial instability can occur within the financial sector and then have serious effects on the real economy, as well as on the balance sheets of the corporate, household and government sectors. However, as Reinhart and Rogoff remind us[5], the links can go in the opposite direction as well. Slow growth can lead to increased NPL's which then feed back on the health of the financial system – think of Italy today. A complementary thought is that too much regulation, if it leads to slower growth and more NPL's, can actually lead to financial instability by another route.

This said, banks have indeed been the source of many systemic problems? Why is this so? Malcolm claims that they "have to take on a lot of **leverage** to make a competitive return on equity" (and) "This is why they have to be regulated". Moreover, he rightly argues that this regulation then leads to **evasion** (think shadow banking) which should be met with an extension of regulation beyond the banks. Indeed, the failure of this to happen is one of his principal criticisms of the regulatory changes to date.

I agree that bank leverage can be a problem. However, I think the link runs as much from regulation to leverage as the other way around and that "safety nets" contribute significantly to such problems. Bank leverage has in fact been rising for many decades, and higher leverage makes banks increasingly susceptible to runs, whether of deposits or other liabilities. This has led the authorities to introduce safety nets, like deposit insurance. However, the

[4] The response to the special problems associated with G-SIBs was to raise their capital requirements, thus reducing the probability of a crisis. This reduced the need to take other measures to reduce the losses given a crisis.

[5] In their 2009 book "This Time is Different" the authors state (p145) "Severe financial crises rarely occur in isolation. Rather than being the trigger of recession, they are more often an amplification mechanism".

safety nets induce moral hazard which then has to be met with more stringent banking regulation. This in turn induces evasion, and the possibility of runs outside the banking system (which is what actually happened in 2009) and the need for a further extension of safety nets (as also happened) and then more regulation in turn. This is a dangerous and never ending dynamic. Rather than simply extending the scope of regulation, as Malcolm suggests, we should rather call into question our fundamental approach towards ensuring financial stability. I will return to this below.

Malcolm welcomes the recent willingness of the FSB to address the possibility that regulatory changes might have **unintended consequences**.[6] In particular, the FSB have agreed that various regulatory changes might have tied up risk-free collateral in a way that could make markets less liquid, especially under stress. Preliminary investigations by the official sector indicate that these worries might have been overblown, but it will take experience of real market stress to be sure. Second, the FSB has explicitly recognized that increases in capital charges for interbank deposits have caused a worrisome decline in correspondent banking relationships and this threatens immigrant remittances.

To these unintended consequences Malcolm adds the possibility that regulatory changes could prevent institutions from exercising their normal functions as market "shock absorbers". A number of insurance companies have made this claim when assessing the implications of Solvency 3. Finally, and closely related, Malcolm notes that a combination of regulatory change and structural adaption could cause dangerous financial imbalances to build up in novel ways. He is right to remark that those charged with avoiding crises should keep this possibility clearly in mind. Problems need not arise where they have arisen before[7] and commonly they do not.

Malcolm also welcomes the FSB's **willingness to reassess** the net benefits (positive expected but negative unexpected) of regulatory changes to date. A similar willingness to reevaluate has recently been seen in the EU where a "Call for Evidence" questionnaire was sent out to financial institutions. Almost every

[6] See the letter sent by Marc Carney, head of the FSB, to the G20 Finance Ministers and Central Bank Governors on 10 march 2017.

[7] Similarly, Malcolm welcomes the ongoing identification by the FSB of new problems and the associated commitment to investigation and mitigation. In Carney's 2017 letter, he specifically refers to misconduct risks, correspondent banking and remittances, climate related financial disclosures and the implications of financial technology innovations.

respondent agreed that, in principle, a reevaluation was desirable. However, in practice, many also feared that a reevaluation could also mean future regulatory change at a time when the need was rather for regulatory stability. Industry representatives feel that uncertainty about future regulatory change could in itself restrain lending.

The Unexplored Nexus of Regulatory and Monetary Policy

The post crisis period has been characterized by a significant tightening of regulatory standards accompanied by (what I have elsewhere[8] called) "ultra-easy monetary policy" (UEMP). The latter has already raised concerns that it breaches certain traditional frontiers. By purchasing huge amounts of both private and public sector liabilities, central banks have crossed the line into fiscal policy. These actions have distributional consequence as well as implications for government financing. By pursuing macro prudential policies to mitigate the unintended consequences of "lower for longer" monetary policy, central banks have crossed the line into regulatory policy. The instruments they are being invited to use are generally traditional microprudential instruments but used for a different purpose – systemic stability.

Crossing these lines has already raised question about, mandates, powers and accountability. In effect these developments threaten the "independence" of both regulators and central banks. A vigorous political debate is already underway about these issues. What has received less attention is that, since the crisis broke, monetary policy has had its foot firmly on the accelerator, while regulatory policy has had its foot firmly on the brake. In the short term one might say that easy money is expected to provide benefits (stronger aggregate demand)while regulatory tightening is expected to have certain costs (weaker lending) . Conversely, as one looks at the further future, one might say that regulatory changes will have benefits (a more stable financial system) while the unintended consequences of UEMP seem more likely to have costs (higher debt levels, more imbalances etc.). These intertemporal interactions have not received much attention, but they have the capacity for serious mischief. In particular, they invite people to focus on the "benefits" at each time frame while ignoring the "costs". This could well have serious implications.

[8] See in particular White W R (2012) "Ultra easy monetary policy and the law of unintended consequences" Globalisation and Monetary Policy Institute, Federal Reserve bank of Dallas, Working Paper 126, Dallas

Since the crisis, the belief has prevailed that **monetary expansion will prove sufficient** to revive growth and a return to “normality”. The fact that the degree of monetary expansion has had to be greater in the face of regulatory headwinds has been ignored. So too has the likelihood of the still more harmful unintended consequences of just such a monetary expansion. Another important implication of this belief is that governments have faced a reduced sense of urgency to finally resolve the crisis through debt restructuring and even debt relief. Malcolm correctly notes that the US took significantly stronger steps in this regard than did the Europeans. European governments have to date chosen to followed the path of forbearance also chosen by the Japanese after their crisis of the early 1990’s. Predictably, in both cases, banks were very reluctant to make new loans. Nor was it supportive of overall eurozone growth, after the European crisis began in 2019, for regulators to encourage core country banks to withdraw funding from peripheral countries.

As to the further future, the belief that has prevailed is that **regulatory changes will prove sufficient** to prevent future financial crises. Thus, the further build up of debt since the crisis (among the longer term costs) can also be ignored. The IIF estimates that global non- financial debt (households plus corporations plus governments) rose by $70 trillion over the last ten years to a current level (end 2016) of $215 trillion or the equivalent of 325 percent of global GDP. This implies that the process of deleveraging, which typically accompanies the “bust” following a credit “boom”, has not yet even begun. Further, much of this new debt has been accumulated in emerging market economies, not least in China, with infusions of foreign credit by asset management firms being a new variation on the old theme of destabilizing capital inflows. The upshot is that, while expansion in emerging markets was part of the solution to the crisis in advanced market economies in 2009, emerging markets are now part of the problem.

Another reason for the prevailing optimism about future financial stability has been the addition of a macroprudential framework to the more traditional use of microprudential regulatory instruments. The former framework provides a new focus on systemic stability and allows for discretionary changes in regulatory instruments in response to indicators of growing systemic stress[9]. However, I think Malcolm is right in stating that “the measures of prudential

[9] The more traditional microeconomic framework focussed on the health of individual institutions and was essentially static over time.

oversight adopted up to now are far from providing effective mitigants to major financial system-wide risks".

First, it is not comforting that the institutional framework for assessing system-wide financial stress is radically different in all the main financial jurisdictions. Second. There is no consensus on the best indicators of emerging financial stress. On the one hand, the G20 (and the IMF) have mostly preferred highly disaggregated "risk map" indicators which attempt to identify stress point in the financial system in real-time. On the other hand, the BIS prefers to focus on highly aggregated series, such as credit or debt growth relative to some scaling factor. Third, it will always be hard to muster the political will to tighten regulations for macroprudential purposes when the indicators give mixed messages while everyone is making large profits from the prevailing state of affairs.

An important and complementary implication of this belief, that regulation has put paid to future crises, is that ex ante steps to prepare for managing such crises are not needed. Indeed, the current mind set is similar to the one that prevailed prior to the onset of the crisis in 2009. At that time, generally accepted macroeconomic models (DSGE et al) ruled out such crises by assumption. Arguably, the capacity for crisis management is even worse today than it was then. The Dodd-Frank bill in the United States has at least six provisions that constrain the Fed's capacity to act as a lender of last resort to individual financial institutions.[10] Moreover, with the dollar still the key international reserve currency, non US financial institutions will likely be short of dollars in the event of another crisis. The Fed has, admittedly, established a network of swap lines to deal with such eventualities. However, it retains the unilateral capacity to deactivate such lines. In addition, it is uncertain whether Congress might also object to the Fed lending huge sums to foreigners under agreements to which Congress had had no input.

In short, post crisis regulatory and monetary initiatives have been totally uncoordinated. The result is that the global economy might be even more exposed to future crises than it was in 2007.

Where to From Here?

[10] The Bank of Japan also faced similar regulatory constraints in the 1990's. That is why they felt forced to resort to "system wide" liquidity injections; aka, monetary policy.

As suggested above, simply filling in the **regulatory** holes will not be a sufficient response to avoid future systemic crises. As the system constantly adapts, actively seeking to avoid the effects of regulation, the regulatory and supervisory authorities will always find themselves left behind. Thus, this "whack a mole" approach seem doomed to longer term failure. Further, even good regulation has its downsides. The costs of increased inefficiency (both static and dynamic) due to regulation must be less than the benefits of reduced instability. Regulations also lead to distortions, and the "need" for ever more regulation. They can also lead to a number of financial agents being forced to respond in the same way to shocks of various sorts. This could exacerbate systemic problems rather than reduce them. Against this rather pessimistic assessment of the merits of still more regulation, two other approaches might be suggested.

A first alternative, evolutionary rather than revolutionary, is to put relatively more emphasis than has been done to date on the non-regulatory "Pillars" of Basel 2. **Self-discipline** and incentives for prudent behaviour should be pursued much more vigorously. Public safety nets need to be rolled back and the losses suffered by bad management decisions need to be borne more directly by those who made them[11]. Greater efforts should go into improving the sense of "fiduciary responsibility" on the part of those responsible for other people's money. Compensation practices should be changed to discourage "short- termism" and encourage value investing. In principle, legal redress (prison and fines) should threaten people not shareholders[12]. **Market discipline** could also be pursued in a variety of ways. How could auditing and accounting practices be reformed to give a clearer and more reliable guide to future profitability (ie better highlight risk taking)? Is the right data being collected from financial institutions and is it being made known to the market in the right way? Surely something is wrong when even Warren Buffet says he cannot understand bank financial reports.

Should such an evolutionary approach to regulatory reform be chosen, then complementary changes might be suggested for monetary policy. Monetary policy should be assigned joint responsibility with regulatory policy to lean against practices (excessive credit and debt creation) thought likely to lead to

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[11] If restoring unlimited liability is desirable, then it should be admitted that it was a mistake to list publically the shares of financial institutions in the first place.

[12] In practice, it I often hard to identify the individuals responsible for "imprudent" behaviour. Beyond that, it is often hard to prove "criminal intent" as opposed to "managerial incompetence". In a well- worn phrase: "Is this the work of a fool or a knave?"

financial crisis. Neither acting alone would seem adequate to the task. The implication for monetary policy would be that the horizon for achieving the current objective of “price stability” would have to be extended well beyond the current horizon of two years. While for some this might seem revolutionary, it is actually quite close to how the Swiss National Bank has been successfully operating over many decades.

A second alternative to avoiding financial crises is more revolutionary than evolutionary, and has been proposed recently in a book authored by (a pseudonym) Jonathon Macmillan[13]. In large part the book advocates adoption of the “Narrow Money” proposals first made by the Chicago School in the 1930’s and also endorsed by Irving Fisher[14]. However, a strength of the book is that it takes explicit note of ongoing technological developments. Importantly, this allows the author to suggest ways to overcome the “boundary problem”; where technology exacerbates the risk of money-like liabilities being created by shadow banks. Recent experience indicates that this is a far greater problem today than in the1930’s. As well, it allows them to suggest plausible ways in which Fin Tech might allow non banks to hold assets (and make loans) similar to what banks do today. In this way, we might avoid the worst excesses of the current system while ensuring that true “savings” are efficiently allocated to those who wish to borrow.

To raise the issue of implementing a narrow banking system is likely “pie in the sky”. All those operating the current system have a vested interest in maintaining it. This does not just include the bankers themselves, and they profits they make. Narrow banking rules out “runs”, and therefore the whole apparatus of safety nets and regulatory oversight is no longer required. Many jobs, and many long held beliefs will be at risk. However, absent such a revolutionary approach, I fear that “more of the same” regulation will only give us “more of the same” financial crises. If my conclusion is correct, and of course I hope it is not, the McMillan proposals are worthy of some serious consideration by those who purport to be serious analysts.

[13] McMillan Jonathon (2014) “The end of banking: Money, credit and the digital revolution” Zurich/One Economics, Zurich

[14] There has been recently growing interest in such proposals. In Switzerland there will be a referendum on what is called the “Sovereign Money Initiative”. In the United Kingdom, a group called “Positive Money” is advocating something similar.