The Macroprudential and Microprudential Regulation of Large Financial Institutions Within a Growth Agenda: Coming Back to Basics

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Preliminary and Incomplete / Comments welcome

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Outline

- **Introduction: wide angle on public policy towards risk in society (financial markets and institutions; labour markets; real investments; government finance; public policy): the need of an integrated approach**
- **A brief history of the crisis**
- **Major factors: subprime mortgages? faulty risk management? loss of confidence in the financial sector? Inefficiently designed bonus systems?**
- **Stimulus plans: the U.S. last quarter century**
  Job gains and losses: creative destruction
- **Deficit and growth: friends or enemies?**
- **Challenges and perspectives: regulation, instruments and institutions**

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Introduction: wide angle on public policy towards risk in society

- **Financial system infrastructure**
- **labour markets**
- **real investments (R&D, innovation, technology, organization)**
- **government finance**
- **public policy**

The need of an integrated approach covering more than financial regulation

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A brief history of the crisis

- Remarkable development of
  risk management and liquidity management tools
- Power of incentives
- Ill-advised political interventions
- Confidence: losses and gains

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A brief history of the crisis

- Subprime mortgages?
- Financial engineering: securitization, ABS, CDO
- Bear Stearns, Fannie May / Freddie Mac, Lehman, AIG
- Interbank lending freeze: Repo size

  Banks started distrusting each other when bank managers suspected and/or found out that risks were as badly managed in other banks as they were at their own!

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The loss of confidence in the banking sector and financial system

– "What happened in September 2008 was a kind of bank run. Creditors of Lehman Brothers and other investment banks lost confidence in the ability of these banks to redeem short-term loans. One aspect of this loss of confidence was a precipitous decline in lending in the market for repurchase agreements, the repo market. Massive lending by the Fed resolved the financial crisis by the end of the year, but not before reductions in business and household spending had led to the worst U.S. recession since the 1930s."

(Robert E. Lucas Jr. and Nancy L. Stokey, University of Chicago, *Understanding sources and limiting consequences: A theoretical framework*, Federal Reserve Bank of Minneapolis, May 2011)

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The loss of confidence in the banking sector and financial system

– "The financial crisis was not caused by homeowners borrowing too much money. It was caused by giant financial institutions borrowing too much money, much of it from each other on the repurchase market."

(Mary Fricker, *RepoWatch*, April 2011)

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The loss of confidence in the banking sector and financial system

- Repo has a flaw: It is vulnerable to panic, that is, 'depositors' may 'withdraw' their money at any time, forcing the system into massive deleveraging. We saw this over and over again with demand deposits in all of U.S. history prior to deposit insurance. This problem has not been addressed by the Dodd-Frank legislation. So, it could happen again. The next shock could be a sovereign default, a crash of some important market -- who knows what it might be?"

  (Gary B. Gorton, Yale School of Management, August 2010)

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- Remarkable development of modern finance:
  insurance, derivatives, credit default swap (CDS)
  Risk management, but increase in the systemic risk (?)
- Creation of quasi-money: asset-backed securities and other forms;
  decrease of bank deposits: 18% of the GDP in 1965, 5% in 2005;
  efficiency gain, but a significant increase of systemic risk:
  quasi-money is not money, while cash is cash
- FED monetary policy
  TR : from 47G$ on 9/10 2008 to 904G$ on 1/14 2009 (674G$ on 2/11)
  MB: from 840G$ on 9/10 2008 to 1741G$ on 1/14 2009 (1522G$ on 2/11)

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Restoring confidence in the banking sector and the economy

- Confidence is both private capital and social capital, posing serious problems of coordination and incentive.
- Manipulation and falsification of information destroys confidence: "... in reporting its financial results, Fannie [Mae] was masking its insolvency through fraudulent accounting practices." (Jason Thomas, White House economist, FCIC)
- Political intervention in GSE + indulgent attitude of regulators
- Flaws in performance incentive programs
- + The inflexible mark-to-market rules in a context where the loss of confidence is causing relevant markets to disappear

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Restoring confidence in the banking sector and the economy

- For there to be hope of getting out for good of the recent recession, there is a need to tighten the disclosure of information on risk, to ensure the independence of regulators and, as a way of achieving this, to make greater use of private regulatory bodies (with a significant reputation capital at stake), to promote a better understanding of an effective structure of performance incentive mechanisms, and to loosen the mark-to-market accounting rule in light of the net present value (NPV) economic rule.

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Inefficiently designed bonus systems

- Mortgage brokers, lenders, “securitizers”, fund managers were motivated by the perspective of bonuses that were not corrected on the basis of the risk level incurred, at least not on the basis of the downward risk.
- Incentive pay: moral hazard, adverse selection, cooperation inducement (team work, contractual relations), counteracting costly or unproductive institutional and/or regulatory constraints
- 12 principles of incentive pay systems (MB in REP - forthcoming)
- 38 recommendations of Jensen and Murphy (2004)
- Principle of deferred compensation (P#11); bonus banks (J&M R#26)

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Reforming capitalism: beware of the sorcerer's apprentices

1981-2007	USA	Canada	Québec
– Real GDP per capita:	66%	54%	51%
– Employment:	45%	50%/53%	38%
	45.7M	4.50M	1.06M

– CAN/USA in PPP: 91.1% to 83.7%

The quality of an investment strategy, chosen and implemented prior to a crisis, cannot be judged on the basis of results observed afterwards

At the same time, it is important not to ignore the perverse effects of policies aimed at compensating individuals and companies who lost money after their strategies failed.

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A neglected phenomenon: creative destruction

Private Sector Jobs created and lost, average per quarter
(seasonally adjusted; establishment basis)

Period	Jobs created / qtr	Jobs lost / qtr	Net jobs / qtr
1992.III – 2007.IV	7.890 M	7.489 M	400.9 K
2008.I – 2010.I	6.598 M	7.638 M	(1039.9 K)
2010.II – 2010.IV	6.827 M	6.347 M	480.7 K

Private Sector Jobs created and lost, average per quarter
(seasonally adjusted; firm basis)

Period	Jobs created / qtr	Jobs lost / qtr	Net jobs / qtr
1992.III – 2007.IV	6.553 M	6.138 M	414.7 K
2008.I – 2010.I	5.305 M	6.380 M	(1074.4 K)
2010.II – 2010.IV	5.654 M	5.223 M	430.3 K

One can only wonder how disruptive indiscriminate government interventions in this process can be.
That is food for thought

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Deficits and growth: friends or enemies

- The relationship between public deficits and economic growth is fuzzy at the very least, and the connection between them is debatable.
- From 1990 to 1995, the Canadian government's budget deficit stood at an average of 5% of GDP, which was a major improvement over the previous five years. From 1997, these deficits gave way to surpluses until the recent recovery plans. What do we know about the impact of this reversal – rather unusual among OECD countries – on growth?
- From the bottom of the class (G7) in 1985-1995
  to the very top in 1997-2002 in terms of economic performance:
  Canada as the model student in the class!
- If government assistance is deemed necessary, do it through an auction aimed at transferring the contract to the party offering the best price.
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Challenges and prospects

1. Refocus the role of governments on the conditions for job and wealth creation
2. Modify mortgage and other contracts for a gradual automatic adjustment of conditions to major changes in the relevant indicators (Zingales, Vallée)
3. Implement proper macroprudential and microrudential rules
4. Resist political and social pressures toward protectionism

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Implement proper macroprudential and microrudential rules

- "A microprudential approach is one in which regulation is partial-equilibrium in its conception and is aimed at preventing the costly failure of *individual* financial institutions. By contrast, a macroprudential approach recognizes the importance of general-equilibrium effects, and seeks to safeguard *the financial system as a whole*. There seems to be agreement among both academics and policymakers that the overarching orientation of financial regulation needs to move in a macroprudential direction" (Hansen, Kashyap and Stein, JEP 2011)

- "We find that systemic capital allocations can differ by as much as 50% from 2008Q2 capital levels and are not related in a simple way to bank size or individual bank default probability. Systemic capital allocation mechanisms reduce default probabilities of individual banks as well as the probability of a systemic crisis by about 25%. Our results suggest that financial stability can be enhanced substantially by implementing a systemic perspective on bank regulation." Gauthier, Lehar and Souissi (Bank of Canada 2010)

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Implement proper macroprudential and microrudential rules

[group of experts of the G20, Univ. of Toronto, Feb. 19-20 2009]

Micro-prudential rules

- The % (risk premium) as a weight factor for capital reserves.
- Stress tests and external VaR
- Make credit rating agency (NRSRO) accountable of their ratings (PD, LGD): Is reputation capital enough?
- Agency problems remain important at several levels

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Implement proper macroprudential and microrudential rules

[group of experts of the G20, Univ. of Toronto, Feb. 19-20 2009]

Macro-prudential rules

- Make capital reserve ratios
  higher in normal economic periods and lower in recessions
- Increases in capital reserve ratios as a function of the growth in credit, in asset prices, +++
- Make capital reserve ratios larger for bigger, more connected and more complex banking institutions (« too big to fail »)

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Implement proper macroprudential and microrudential rules

[group of experts of the G20, Univ. of Toronto, Feb. 19-20 2009]

Macro-prudential rules

- Facilitate orderly bankruptcy of large and complex banking institutions: Contingency plans (regulatory) for the transfer of control and the sharing of losses and costs
- Progressively abolish Fannie Mae, Freddie Mac, FHA, FHLB in favour of direct help to the neediest
- Abolish restrictive rules on bank ownership (governance, role of Boards of directors)
- +++

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