Post Credit Crunch Financial Reforms: Peering through the Blizzard

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Introduction

President Obama took a big stride ahead of the pack of international governments and regulators with what is being called his '$30 Billion Speech' (in honour of the stock market falls within 2 minutes of the speech) on financial regulation reform. The details remain hazy, but the big strategy is clear – the structure of the financial system needs a major overhaul. For those that have followed the unfolding regulation that has been produced to date, Obama's speech marks a watershed, with the focus of reform moving on from a 'more and better capital' strategy to a 'structure reshaping' strategy.

Now is an excellent time to pause for breath and consider the state of post credit crunch regulatory reform. IMF estimates of government funding supplied to the financial sector over the course of the credit crunch run to $10 trillion globally. With the culpability of financial regulation beyond doubt, it is no surprise that a blizzard of new reforms has been unleashed. In the last 6 months of 2009 there were at least 10 major regulatory publications[1]. Following this blizzard, the first stages of reconstruction appear to be taking shape, while the second stage appears poised to kick off.

What are the aims?

The aim of reform has been and remains simple, to create a more robust financial system. Since the British Government stepped in at the height of the crisis to recapitalise the UK banking system, the first and most immediate need was clear – more and better quality capital holdings. Following the fire fighting measure of increasing capital as an emergency measure, the next logical step was to enshrine the 'more and better capital' mantra in regulation, and changes to do this that have been outlined during 2008 and 2009. It is not a simple set of changes. The majority are about linking better risk measurement to capital levels (leaving to one side some important proposals, such as the leverage ratio and changes to what counts as capital), and can be broadly categorised into three fundamental areas: liquidity risk, market risk and procycliality.

As President Obama made clear, the problems of the regulatory system go beyond just holding more capital. To truly build a system that is not only stronger in the face of crisis, but also less prone to it, issues about the structure of the financial system must also be addressed. We return to this point below.

Addressing the Failures: Liquidity Risk

Arguably the most urgent area for reform is that of liquidity risk. What regulators are asking is for firms to look at how long they could function when normal sources of liquidity dry up in response to a financial crisis. The essential question being asked is 'when confidence is gone and no-one will lend you money have you got enough ready cash to last until either the storm passes

[1] Issued by either the Basel Committee on Banking Supervision, the FSA or the International Accounting Standards Board.

or the policy response is clear and in operation'. This may be simple in principle, but the raft of detailed system, monitoring, reporting and stress testing requirements are not and will make this a difficult exercise for firms to complete.

Addressing the Failures: Market Risk

The response on market risk has been more varied, with a rather long list of different new actions and analyses required. This is partly because some detailed, but important failings had to be addressed, as well as the more general problem with the risk assessment framework. The detailed bits are principally to do with 're-securitisations' (e.g. the infamous CDOs) and 'off-balance sheet instruments' (loans that weren't meant to be part of the bank, but turned out to be part of the bank during the crisis). The actions have been to put in requirements that need much more capital to be held against these sorts of assets. The 'more capital' goal has been fulfilled on the general level by introducing a whole new charge to cover some failings of the VaR system called the Incremental Risk Charge (IRC), as well as requiring the VaR system used for calculating regulatory capital requirements to be based on data from a bad experience (i.e. the credit crunch experience). The IRC requirement, not having a prescribed method and addressing a very challenging problem, looks to be the most difficult aspect of the measures on market risk. This will involve some complicated modelling and firms that are required to produce this analysis will want to get moving as soon as possible, if they have not already started a project.

Addressing the Failures: Procyclicality

Procyclicalty was, to be frank, a bit of a disaster arising from the regulation on capital and loan-loss provisioning (known as Basel II and IFRS, respectively[2]). What the word means, in this context, is that as economic conditions deteriorate financial firms need to find more capital. For a stable banking system and flow of lending to the economy, firms should be able to use some of the capital they hold to absorb losses during a downturn, and not have to go out and find more capital over and above what is needed to cover losses. As it was, the capital requirements and provisioning frameworks structure resulted in a double whammy of extra capital that had to be financed at the worst possible time.

The solution to this problem is to stabilise regulatory capital requirements and then allow a general pot of cash to cover losses, whether it is called a 'provision' or a 'capital buffer'. Regulators have taken steps toward this by allowing a method to stabilise capital requirements through good and bad times for some key portfolios (known as the 'Variable Scalar' method) and by proposing to switch the entire basis of provisioning for financial institutions. The provisioning side is currently in consultation with the IASB[3], but involves making a provision against every loan at the time it is written, to reflect the chance that it won't be paid back, rather than initially assuming you get the full amount back on every loan you make and then finding some money to put aside once a loan actually starts to go bad.

Firms can look on these changes as a return to common sense, where they can put money aside as required and not have the nightmare capital management problems attendant on highly cyclical capital requirements. However, the changes in provisioning need to be carefully thought through as they will make a fundamental change to firms' P&Ls. Provisioning model design and stress testing must integrate with capital buffer sizing if firms are to successfully insulate

[2] These are the names of the major capital and provisioning regulations – Basel II for capital and International Financial Reporting Standard (IFRS) for loan loss provisioning.
[3] International Accounting Standards Board

themselves from deterioration in economic circumstances. The changes to provisioning method being proposed are radical and, of all the regulatory changes proposed so far, may be the most fundamental in affecting how firms' performance and quality are assessed. The sector as a whole and particularly the risk community need to get heavily involved in the consultation and not just leave it to the accountants. Adding extra spice to these issues is the proposal in the current BIS consultation to restrict the ability of a firm to pay bonuses and dividends when it is using its capital buffer. This is not just a return to old accounting standards.

That concludes a brief précis of changes that are already either in place or well in motion. Their combined effect is a strategy focussed on making the system safer by enforcing higher capital requirements for those most exposed to risks whilst also trying to making better capital management possible. These changes will make the financial system safer than it was. But there is a strong argument, on which there is consensus among UK regulators, that more capital on its own will not make the system less prone to crisis.

Beyond More Capital? Deposit Takers and Casino Capitalism

Going beyond the 'more and better capital' strategy requires something to be done to ensure risky trading is not insured by the state along with ordinary people's deposits. This is the so called 'moral hazard' problem which is at the very core of the so called 'Volcker Rule' outlined in Obama's speech.

The 'Volcker Rule':

"Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers."

President Obama, 21 January 2010

It is widely accepted that it is necessary for the government to protect savers in deposit taking institutions to preserve confidence in the banking system. The concern is that if these institutions that have a de facto government guarantee engage in trading in risky assets there is scope for bankers to be rewarded handsomely when the trading pays off but for taxpayers to be on the hook for huge losses when it does not. The incentives are in place to encourage the risky trading activities that brought on the crisis. Where large, highly inter-connected institutions engage in deposit taking and high risk trading, then not only does a perverse incentive structure exist, but also a financial network that is an ideal propagation mechanism for financial crisis.

In the UK there have been calls for a policy similar to that announced by Obama, for investment banking functions to be split from deposit taking banks via legislation, most notably from Mervyn King[4]. Adair Turner has also raised concerns about this issue, but has indicated a preference for regulation which would make engaging in risky trading too expensive for retail banks. The current FSA view suggests buttressing this 'pricing them out' method by forcing institutions that do both to simplify their structure, so that the trading arm could be left to fail and the deposit taking bank saved. We can expect more debate and action in this regard, with the latest FSA Turner Report follow up conference and discussion paper focused on this issue.

There is much to discuss. To date there has not been a clearly articulated basis for a strategy which weighs the incentives of a deposit taking institution considering risky trading activity

[4] Speech to Scottish business organisations, Edinburgh, Tuesday 20 October 2009

against the additional costs of capital, comparing the returns on capital across different asset classes. The FSA expects the new requirements to triple capital required for a trading book, but is this enough to outweigh the advantages of the protection afforded by being wedded to a deposit taking institution? Is the market competitive enough to mean that this cost could not be absorbed in the margins made by investment banking arms in good times? Clearly more work would also be required to establish how a regulator might let one part of the institution fail and save the other and how the repercussions would play out in a scenario where the institution in question was systemically important.

Another potential problem with this type of reform is that stand alone investment banks may remain systemically important due to size and interconnectedness with deposit taking institutions. As the Lehman bankruptcy showed, letting a large investment bank fail can have wide ranging consequences. Ultimately the U.S. government had to effectively stand behind the other stand alone investment banks and allow them to take deposits so they could access government support. It may not be enough simply to say that deposits are safe so investments banks and hedge funds can go down and we won't worry about them anymore.

Back to the old routine?

The financial system will always experience periodic crises. A huge amount has been done, following a 'more and better capital' strategy, to make the system safer when a crisis comes along. Unless something is done in respect of a strategy to address structure, the financial system remains open to a repetition of debilitating crisis perpetuated through high risk trading.

Things are still evolving, with the debate moving on and changes being implemented. In the meantime, however, there are worrying signs that things may already have slipped into the old routine. There are fears emanating from the growth in the 'carry trade', where you borrow in a currency with a very low interest rate and lend the money out in a country with a higher interest rate, making money for nothing on the difference and doubling up if the currency movements go in the right direction. The only problem with the carry trade is that interest rates can move and so can exchange rates and not always in your favour. Compound that with the scenario that things move the wrong way for an awful lot of people at the same time and you could get some nasty losses in the financial sector. Whether this will happen, and whether it would affect a major UK bank if it did, remains an open question. But that isn't the point – it should be firmly out of the question.