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The Finance Market Watch Program @ Re-Define

Principles for financial system reform

Given the number of financial sector regulation proposals on the agenda, it might be useful to discuss the need to reshape regulation through a lens of some broad principles. Unless the reform agenda is guided by a set of fundamental principles it is more than likely that it would lose its way and end up not achieving what it is meant to do – create a financial system that supports the real economy and does so without posing a burden on tax payers. In this section we highlight the most important principles and discuss what they imply for regulatory reform discussions.

Competitiveness

The 20%-25% return on equity for banks, 2/20 % hedge fund fee structures and more than $100 billion in annual bonus payouts, all salient features of the pre- crisis financial landscape were symptoms of too little competition and excessive leverage. Things came to ahead in the United States when the financial sector, which is supposed to merely facilitate the real economy, accounted for as much as 40% of all corporate profits in the run up to the crash. This profit came at the cost of customers, tax payers and actors in the real economy.

Consolidation in the financial sector was driven by public subsidies meted out to institutions considered 'too big or too complex to fail'. An important corollary of this subsidy is that it confers on them a significant advantage over smaller rivals, increases barrier to entry and distorts competition. Employees and shareholders are able to garner excessive rewards in the non-competitive system and this together with the protection against failure combined to skew incentives and encourage speculative and destabilizing behaviour.

Barriers to entry need to be lowered and financial institutions need to be broken up so their failure no longer poses a threat to the system. This would not only deliver a much better deal for both customers and investors but also for taxpayers since such a system would also be less likely to crash.

Diversity

Soldiers crossing a bridge are asked to break step else the bridge would become unstable and collapse. Likewise, financial stability comes from diversity of behaviour. When everyone wants to buy or sell at the same time, we get asset price bubbles and collapses. As we have seen in the earlier sections, this unfortunately has been the trend in recent years.

What we need is the whole range of financial institutions – savings banks, insurance firms, merchant banks, pension funds and development banks doing what they are supposed to do. In the run up to the crisis banks behaved increasingly like hedge funds through their proprietary trading operations, and hedge funds became shadow banks. Some insurance firms such as AIG tried to be both.

Current regulation allows market prices and institutions' own judgement of risk to influence how much capital they hold. Since this capital is held to guard against market and institutional failures in the first place, there is a big contradiction here. This, together with the use of similar risk management and bonus incentive systems drove everyone to invest in the same assets at the same time and reduced diversity. It made the financial system more pro- cyclical, unstable and prone to systemic collapse.
Portfolio diversification worked well only as long as access to asset markets, geographic reach and the information available to different investors all differed since the various buckets of investments were genuinely distinct – i.e. there were many different baskets.

Advances in information technology meant that nearly everyone has access to the same asset price data more or less at the same time; capital account liberalization has meant that for all practical purposes all large and significant financial markets are now open to overseas investors; regulation has driven more and more financial actors to use similar market price incorporating risk management systems; and the growth of the bonus culture and annual shareholder maximising objectives has made more and more financial actors behave identically in a bid to maximise their income.

The pursuit of diversification against this background predictably led to an increased degree of uniformity in the financial system which increased systemic risk and made it fragile to external and internal shocks.

That is why financial institutions need to be regulated by what they do not what they say they do. Capital requirements need to be mandated by regulators not markets or own judgement. Diversity can come from different investment horizons, incentive systems, risk appetites or regulatory requirements and should to be actively encouraged in the new regulatory regime.

Regulators around the world led by the G-20 are pushing for the adoption of high and common standards but this push needs to be thought through. The adoption of similar VaR based risk management systems and similar capital adequacy requirements across credit institutions is likely to have contributed to the ongoing crisis. If the same standards are universally adopted then this in itself increases the homogeneity of the system and reduce diversity.

Simplicity

Because financial regulation lacked broad principles, reactive efforts to 'fine tune' and adjust it have left us with tens of thousands of pages of laws and guidelines which are full of loopholes but act as a barrier to entry nonetheless. Moreover, because these differ across jurisdictions and legal form financial institutions set up a complex network of hundreds of subsidiaries to game the system. This has made them not only too complex to fail but also in the case of behemoths such as Citicorp which has close to 2,500 subsidiaries (427 in tax havens), too complex to manage.

What we need is to hardwire simple and blunt regulation such as caps on leverage, country by country reporting and prohibitions of off balance sheet exposures. This would be more effective if co-ordinated internationally but pan European moves would be a welcome start.

There has been a parallel rise of the complexity of financial products driven by the fact that complexity increases profit margins and opportunities for tax and regulatory arbitrage. It does so by increasing information asymmetry between the financial institutions on the one hand and its customers and regulators on the other.

Complexity in legal structures and products also increases opacity, reduces supervisory effectiveness, and thus increases systemic risk. Regulation needs to push for simplicity in legal structures and in financial products.

Regulation itself should aim to be simple and robust. Excessively complex measures of risk and capital adequacy, for example, lose their usefulness in the face of developments that are not easy to anticipate or calibrate. These are exactly the sort of developments that risk management systems and capital cushions are designed for protection against. So for a rule to be effective, it would need to be simple or supervisors and regulators can get lost in detail. Complex rulebooks are also easy for banks to game whereas simpler rules such as leverage ratios are more robust.

Fairness

Large banks excel in reducing the tax burden on themselves, as well as on their employees and large customers through the use of complex products and legal structures often involving tax havens. In good times, they did not pay their fair share of taxes and in bad times those who do pay their taxes have bailed them out. This is not only unfair but even more important destabilizing since it encourages excessive risk taking.

Polluters must be made to pay so there is an urgent need to crack down on tax avoidance by banks, bankers and their clients. While that can help reduce future abuse, the costs of ongoing and future bailouts must also be recovered from the financial sector through levying financial transaction taxes and levies on bank balance sheets. These are easy to collect, hard to avoid, have a very progressive incidence, have the potential to increase stability and can be implemented unilaterally.

Compensation in the financial sector needs to be regulated sharply downwards to reduce the rewards from excessive risk taking. The best way to make the upside and downside faced by bankers more symmetric would be to cap bonuses to 50% (or less) of salary. Current annual bonus structures of multiples of base salary drive short-termism, speculation and irresponsible behaviour because such behaviour can be highly rewarding especially because eventually it is the tax payers who foot the bill.

More broadly the social contract between banks and the society needs to be revised with terms favouring society over banks. This would need a bevy of new taxes on financial transactions and banks short term funding, strict compensation controls and caps on leverage and liquidity mismatches. No financial system would be fair without removing the subsidy that too big to fail or too interconnected to fail institutions enjoy. This needs to be tackled preferably through radical surgery on the banking system. If this proves to be too contentious then a combination of credible resolution mechanisms and high systemic risk penalties might offer a second best solution.

Alignment with the real economy

While there are some investments that earn genuine short-term rewards, most productivity enhancing investments in the real economy need to have a medium or long-term horizon. That long term horizon is also a way of ensuring that the returns are sustainable and do not come at the cost of long term growth. The financial system, which drives investment flows, has unfortunately become increasingly short term oriented with the average holding period for stocks for example, having decreased sharply to less than a year now. This means that investments of the kind which have high upfront costs but deliver high productivity and profits over the long term are undervalued by the market.

A widely quoted study of companies listed on the Dow Jones Industrial Average (DJIA) found that between 1999 and 2004, nearly half the companies in the index met consensus forecasts or exceeded them by just a penny. Such forecast hugging is simply not possible in the real complex world of large corporations and is a clear sign of widespread earnings manipulation. Exceeding consensus forecast generates a share price spike which is very profitable for CEOs who often get paid in stock. Even more shocking, 78% of executives interviewed in a survey said that they would sacrifice an initiative they expected would create economic value, if it negatively impacted their ability to smooth earnings.

The short term orientation thus not only increases the volatility in the economy but also means that investments that are profitable in the short term but which ultimately destroy value are encouraged and that investments which create value in the long term are priced out of the market. This has serious implications not just for the productivity of the economy but for tackling climate change. Green investments that are clearly profitable in the long term are often underfunded by the market because they entail high upfront costs.

This short term orientation can be addressed through a combination of measures which include an introduction of financial transaction taxes that penalize excessive short termism and speculation, compensation controls that remove the incentive for short termism and differentiated voting rights for long term shareholders.

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