Regulation and Financial Stability: Where are we going?

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Some History

- Banks go bust because they run out of money, not because they become balance sheet insolvent. Dexia, Icelandic banks.

- So earliest regulations on cash and liquidity ratios, not capital ratios. 19th century until 1970s. Consistency between financial stability and control of M, via money multiplier.

- Capital acts as a protection to other creditors in the event of bankruptcy. Abandonment of unlimited liability in 19th century; replaced by transparency and market discipline.

- System transformed by growth of international wholesale markets in 1960s/70s, plus IT. Euro-$ market. Funding liquidity replaces asset liquidity. Formation BCBS.

Capital Ratios

- Capital ratios declined steadily since 19th century. Interest rate tax deductability and focus on ROE; shift from mutual/partnerships to profit maximising Ltd Companies.

- Oil shock leads to intermediation between oil producing and oil importing EMEs in 1970s in euro-$s. Post Volcker crisis 1979-81, MAB.

- US city centre banks bust. Congress angry. Level-playing-field. Volcker (+UK) put pressure on BCBS.

- Basel I Accord 1988. Ratio of Tier 1 and Tier 2 capital to RWAs. What was ratio meant to be? Norm, standard or minimum? Buckets were not finely calibrated. Securitisation. Basel II.

Crisis

- Risk weights politically chosen, mortgages, sovereign debt. Capital requirements eroded. US and European differences manipulated. Mark to Market accounting.

- Result. European banks had core tier 1 equity of about 2½% of RWA, 1½% of total assets (UBS).

- Banks all appeared strong in August 2007, but actually were extremely exposed to asset class down-turn. Drying up of liquidity and fire sales. Maturity mismatch worsens as crisis deepens.

Response

- ‘That must not happen again.’ Much more equity, 9% by June 2012, EBA. Also shift in RWA for trading book.
- But CEOs do not (cannot) issue equity. Book to market value; debt overhang; ROE.
- Why US stress test was so much better than European one.
- Cause of crisis was basic banking/ property bubble, but criticism of banks’ complex trading, prop trades, synthetic CDOs, etc. Plus obscene remuneration.
- Effects. Deleveraging, especially in Europe. Covert protectionism and fragmentation back into national systems. NSFR still to come. Loan to deposit ratio.

Where do we go from here?

- Capital ratios based on pragmatism, not theoretical analysis.

- Play several roles:
    1) Protection of other creditors when ‘gone concern’.
    2) Skin in the game.
    3) Buffer

  (1) and (3) are inconsistent. Taxi analogy.

- Need for reconsideration. Two ratios with a ladder of sanctions in between. Getting there:-

Basel III	4½% equity to RWA
	7% Conservation range

- Limits on bank pay-outs between.