Bank of Finland Top Level Visitor Seminar
Professor Raghuram G. Rajan

The Global Roots of the Current Financial Crisis and its Implications for Regulation

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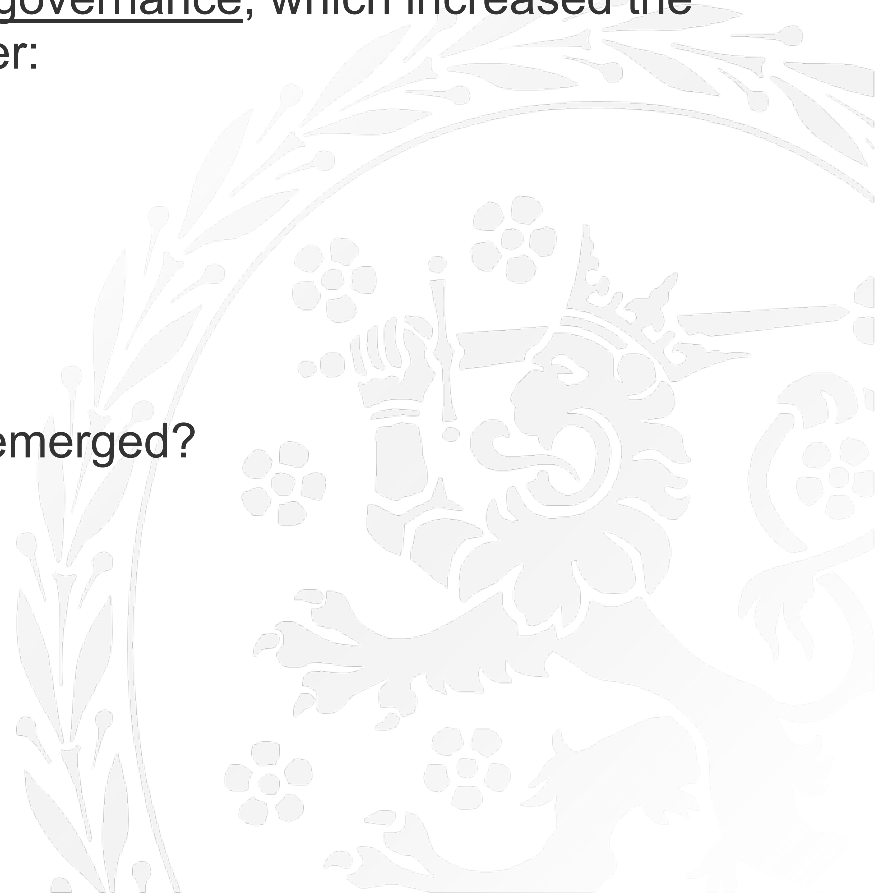
Outline of the discussion

- The crisis has necessitated a comprehensive assessment of the governance and regulatory framework of financial institutions.

- There were failures in all three forms of governance, which increased the potential for the crisis and made it deeper:
    - market discipline;
    - internal governance;
    - official regulation and supervision.

- What key needs for improvement have emerged?



Structured credit instruments at the heart of the crisis

- Rapid growth in mortgage-related securitization and structured credit instruments (CDO, CDO^2…) amplified credit growth.
- Major difficulties in risk measurement due to complexity of the instruments, leading to underpricing of risks.
- Increased leverage and exposures of banks and other financial institutions.
- Problem not in innovation (securitization) as such, but:
  - Extreme structuring of instruments.
  - Lack of understanding of the sensitivity to systematic factor(s) (house prices) passing through the variety of instrument structures.
  - Destabilizing deleveraging and fire sales after the crisis outburst due to excessive leveraging in the first place.
  - Liquidity problems (difficult to find funding for the instruments).
  - Prevailing lack of confidence and uncertainty about losses and capital adequacy of many banks and other institutions.

Improve conditions for effective market discipline

- Complexity and interconnectivity of institutions' risk positions (due to OTC contracting) have created problems for transparency.
- Further disclosure requirements could help, but disclosure should be driven by investor needs.
- Need stronger incentives to creditors and share-holders to monitor and influence management by restricting the public sector safety-net.
  - Need to leave (esp. junior) creditors and share-holders credibly out of the safety-net:
    - Credible deposit insurance arrangements (Gropp and Vesala 2004).
    - Pre-agreed rules to deal with failing banks.
    - Avoid "blanket guarantees" in favour of all creditors!
  - Incentives to influence are reduced by the difficulty of reaching private sector solutions in case of major institutions (Mayes 2008).
- Market discipline to be enhanced as complement to official supervision.

Strengthen internal governance

- Sound internal governance by firms themselves is of key importance – supervisors cannot take the whole burden.
- Clear failures in top management oversight of risks, incentive pay-schemes, approval of new products, risk modeling and model validation.
- A difference to Rajan et. al. (2008): Internal governance is a matter for regulators as well:
  - Managers and traders are given implicit or contractual incentives to take on risks by share-holders.
  - But, the incentives can be “wrong” due to principal-agent problems and failure to incorporate the costs of financial distress and systemic risks.
- Regulation and supervision of the main principles of sound governance:
  - Avoid detailed regulation and interference with the management role.
  - Enforce effectively the Basel II / Pillar 2 requirement to identify and manage all material risks irrespective of the structure of legal entities.

Promote independent supervision of liquidity risks

- Maturity transformation and excessive use of short-term market funding have been major sources of fragility and systemic risks.
  - Northern Rock, Lehman, Bear Stearns, Icelandic banks, SIVs…
  - Many institutions sought income aggressively from upward-sloping yield-curve as in traditional banking, while relying on continuous access to market funding.
- Enhance the supervision of liquidity risks as independent object of prudential supervision.
  - E.g. the size and composition of liquidity buffers, survival periods and stress testing.
  - Requirements might be considered also regarding the diversification of the funding structure.
- Not only banks are "special": The scope of prudential requirements should cover all systemic institutions (failure would threaten financial stability).

Adjust the risk-based capital adequacy rules

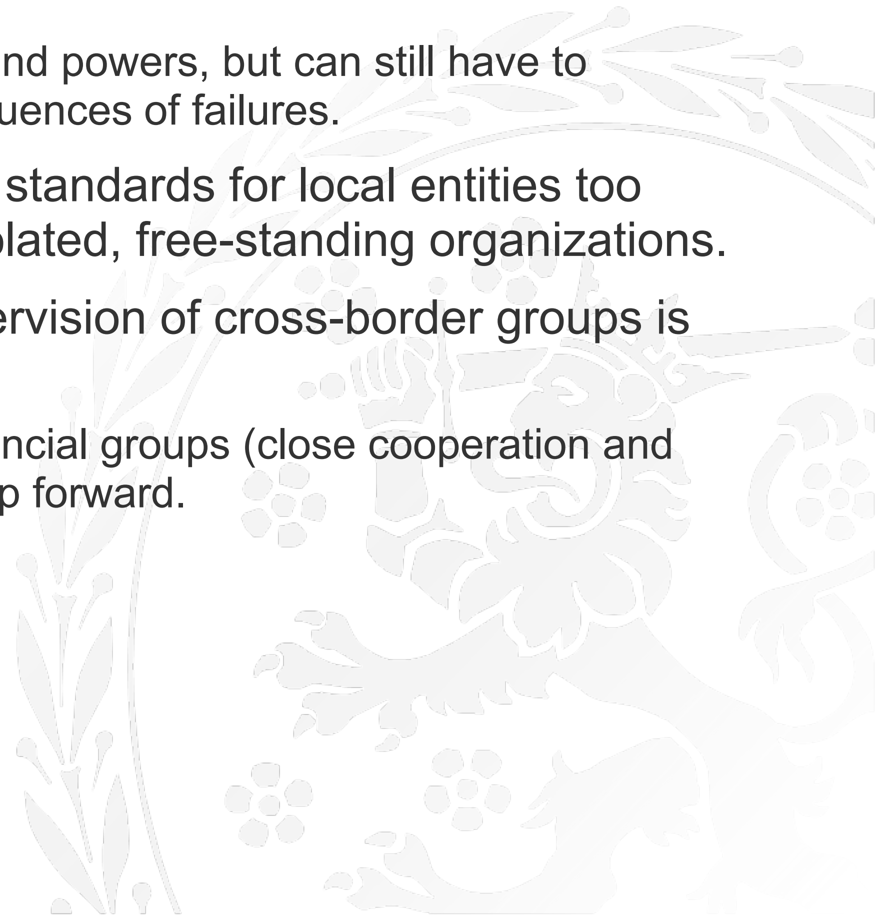
- Risk-adjusted capital requirements (Basel II) can reduce the risk of insolvency to a selected confidence level.
- But, demand accurate risk measurement to prevent excessive leverage:
  - E.g. residual risks in credit risk transfers would have to be covered appropriately – otherwise an increase in leverage.
  - An incremental capital unit can be used to greatly expand assets if unduly judged by internal models to be of low risk.
- A critical review of the Basel II requirements is needed:
  - Higher charges for mortgage-related assets, credit lines and residual risks.
  - Reduce the pro-cyclicality of minimum capital charges (use of longer data and through-the-cycle adjustments in parameters).
- Greater capital buffers (esp. Tier 1 capital) should be demanded in normal times and during an upward part of the business cycle.
- Supervisors should also monitor closely nominal growth rates and non-risk adjusted, simple leverage measures.

Private capital insurance?

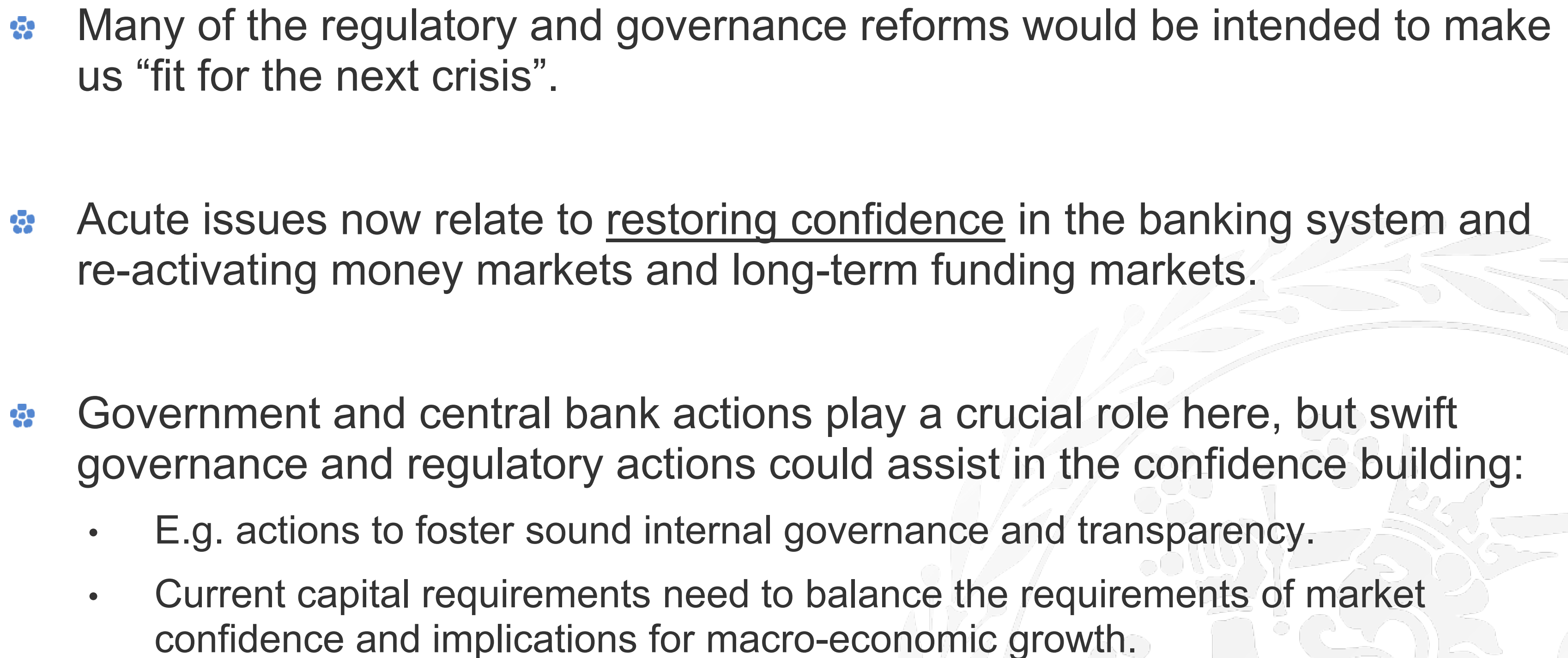
- Rajan et. al. (2008) suggest private capital insurance based on pre-defined banking system-wide triggers.
  - Contingent capital used to boost banks' capital base in a system-wide crisis.
  - Avoid high and costly capital levels in normal times.
- Might be worth considering if existing share-holders could act as the "insurance sellers" (acting as the "first-line of defense")?
- This alternative idea might also be based on bank-specific triggers, which would also work for idiosyncratic capital shortages:
  - Share-holders would inject a pre-specified amount of extra capital in case the bank faces major problems and breaches pre-defined triggers.
  - Share-holders would receive an insurance premium.
  - Increased incentives to monitor the bank's activities and risk taking in good and bad times.
  - Less incentives of to gamble near insolvency.
  - Less incentives for stock price manipulation.

Enhance cross-border supervision in the EU

- National supervision of cross-border banks does not necessarily take into account wider consequences of problems for other countries.
- Financial crisis has revealed this problem especially regarding cross-border branches:
  - Host countries have limited information and powers, but can still have to manage and even payout for the consequences of failures.
- Danger now of host countries tightening standards for local entities too much and insisting them to be run as isolated, free-standing organizations.
- Thus, a European-level solution for supervision of cross-border groups is needed for the longer-term:
  - Collegial supervision of cross-border financial groups (close cooperation and coordination) is a useful intermediary step forward.



Conclusion



- Many of the regulatory and governance reforms would be intended to make us “fit for the next crisis”.

- Acute issues now relate to restoring confidence in the banking system and re-activating money markets and long-term funding markets.

- Government and central bank actions play a crucial role here, but swift governance and regulatory actions could assist in the confidence building:
  - E.g. actions to foster sound internal governance and transparency.
  - Current capital requirements need to balance the requirements of market confidence and implications for macro-economic growth.