September 23, 2013

How should micro-prudential control be strengthened to prevent local and global financial market failure?

Jeffrey R. Shafer

The financial crises in the advanced economies over the past six years have rightly focused attention on failures of financial supervision and regulation. But the results of this focus have not always been constructive in reducing systemic risk while fostering the development of financial markets to meet the needs of an increasingly complex and interconnected global economy. Today I want to briefly outline what we should and should not expect micro-prudential control to do. I will also make a few observations on what else needs to be put in place to reduce the risk of future systemic crises as much as possible. My comments draw mainly on what has happened in the U.S. because this is what I have looked at most closely. But I am sure those of you who know Europe can quickly draw parallels and contrasts with the situation here.

The U.S. Treasury under Hank Paulson put out a “Blueprint for a Modernized Financial Regulatory Structure” in March 2008. It is the fruit of work done before the full impact of the subprime crisis had been felt. I thought at the time that the long-term vision of financial regulation contained in it was sound, and I continue to think so. It identified three regulatory functions.

1. **Market stability regulation** to address overall conditions of financial market stability that could impact the real economy;
2. **Prudential financial regulation** to address issues of limited market discipline caused by government guarantees; and
3. **Business conduct regulation** (linked to consumer protection regulation) to address standards for business practices.

The first highlights macro-prudential oversight needs that were not met before the crisis. The second of these is micro-prudential. With what we saw in the crisis, I would take a somewhat broader view of the market failures that justify micro prudential control—governance failures, for example, led to excessive risk in the run-up to the last crisis. It was not all the result of moral hazard. But the distortion of incentives from explicit and implicit government guarantees can be costly to the government and systemically damaging if not contained. When Walter Wriston, CEO of Citicorp, said thirty years ago that banks no longer needed high levels of capital as long as they were profitable, well managed and growing, he pointed to market signals without acknowledging the role that the government as a backstop was playing in shaping those distorted signals. On the third function, we should note that failure here also contributed to the systemic crisis. When abusive mortgage practices and fraud in documentation went unchecked, risk built up in the mortgage market.

Reflecting moral hazard concerns, prudential regulation has at its core capital adequacy. This means not just assessing capital but also risks—credit risk, market risk and operational risk. It also means assessing exposure to liquidity stresses, something that was neglected before the U.S. crisis and led to capital destruction that multiplied the losses in the housing market. It had been virtually ignored as a risk outside banks and not well supervised in banks before the crisis. This is partly because the objective of micro supervision is to ensure the safety and soundness of individual institutions to protect taxpayer interests. And it is partly because the SEC did not take capital adequacy and liquidity risk as important under its mandate. But when market liquidity evaporated and institutions that had counted on liquidity provided by markets could not survive without assistance, the taxpayer was put at risk when it was provided, and the global economy was damaged when it was not in the case of Lehman Brothers. Some seem to be intent on raising capital requirements enough to absorb any conceivable market liquidity risk. This will only feed shadow banking competition. It is at least as important to reduce exposure to market liquidity risk and to lower that risk in the system.

Looking back, prudential regulation did a poor job of reducing systemic risk for several reasons. Four of them are:

1. It has put emphasis on diversification and the hallmark of a systemic crisis is that correlations increase dramatically. The gains from diversification disappear.
2. Regulators get caught up in the hope, complacency and optimism that allow imbalances to build up in the financial system and in individual institutions. Other policy objectives impinge on risk assessment. Thus
   - Mortgages have generally received low risk weights.
   - Sovereign lending has been treated as riskless.
   - Capital requirements have tended to fall during the upside of economic cycles.
3. As noted, liquidity has been poorly dealt with, in part because regulatory criteria have lagged behind changing market practices.
4. The focus on compensating for moral hazard created by government guarantees has left systemic risk to grow out of sight of the prudential regulators where formal government support was not present.

The first two of these shortcomings should be attacked, but we must be realistic about how well they can be corrected. As for the third, the liquidity ratios mandated by Dodd-Frank go in the right direction but do provide comfort that we will avoid another meltdown. Closer regulation of the liquidity of individual institutions can go some way toward creating a more stable system, but the fundamental problem is one of how the system functions under stress, not what ratios are applied to individual institutions

The fourth weakness of prudential regulation was the fatal systemic flaw. The center of the liquidity meltdown in the U.S. was not in banks but in non-banks—the ABCP market and the SIVs and other conduits that they funded, Bear Stearns, Lehman Brothers, AIG, and the money market mutual funds. The SEC, which was responsible for regulating all of these except AIG, cared little about safety and soundness so long as rules written by lawyers were being followed. AIG was subject to no meaningful oversight. Five years after Lehman's bankruptcy, one thing has changed—the remaining large broker-dealers, Goldman Sachs and Morgan Stanley have become bank holding companies subject to Federal Reserve prudential oversight. But the system is still vulnerable to weak institutions outside the prudential net. The failure of the SEC to take adequate action to ensure the viability of money market mutual funds in distressed markets is a sad case. In addition, institutions outside the bank holding company net are well placed to grow and we have seen the failure of one that pursued growth aggressively, MF Global, which sent some reverberations through the system. We should expect more surprises like this. Higher capital requirements on banks will favor shadow banks even more in the future. Hedge Funds are also lightly regulated, although risk management by their counterparties, pressed by the Fed, has limited their liquidity vulnerability to levels well below those that prevailed when Long Term Capital Management had to be rescued in 1998.

The effectiveness of the framework for monitoring systemic risk established by Dodd-Frank will be most important for systemic stability. A Financial Stability Oversight Council was established along with an Office of Financial Research to provide analytical support. This arrangement is not ideal—the fragmented U.S. financial regulatory structure already had too much room for turf wars and for problems to fall through the regulatory cracks—but it does provide a mandate for systemic risk oversight for the first time, and that's a good thing. The Oversight Council can be effective in this role if and when it identifies problems, although further strengthening of its powers will be needed as it identifies emerging stability threats.

Micro-prudential oversight, even if not systemically focused, can support the Oversight Council in important ways. What examiners see emerging as new practices needs to be reported so that their systemic implications can be assessed. A good example of this kind of sharing of perspective appears to have been the sharpening focus on bank commodities activities. Regulators reportedly became concerned about the aggressive growth in commodity holdings of banks over the past several years, as well as the risks associated with businesses regulators don't consider core to banking. A broad debate over the role of financial institutions in commodity markets is now underway involving both market and systemic concerns. Putting together a global picture from the pieces looked at by micro regulators can also give early warning of crowded trades that carry systemic risk.

Stronger individual institutions resulting from better micro prudential supervision will go some way to create a sounder system. But it is far from sufficient, as we learned five years ago. A focus on the systemic forest is critical. The information gained from looking at the institutional trees can contribute to this if it is not locked up in regulatory agency silos.