

Financial Innovation and Regulation in the Global Economy: Next Steps

drafted by:

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Outline

- Background: global imbalances & financial fragility
- Not a single crisis but a sequence of crises: Is a political economy cycle of finance ending?
- The key theoretical/policy errors behind the crisis:
 - questionable risk pricing models from finance theory
 - fallacious evolutionary view from banks to markets
 - improvident monetary policy conduct by the Fed
- Will Europe and Asia return to Bank-Based Finance?
- Policies to preserve financial innovation/globalization
 - the prospected Financial Reforms
 - would these reforms suffice?
- The role of regional policies

Background: global imbalances & financial fragility

➤ Emerging economies' current account surplus & For.Ex.Reserves growth (a) & share (b): portfolio choice or insurance against crises?

panel (a)

panel (b)

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Not a single crisis but a sequence of crises

➤ Vis-à-vis the previous period: frequency of crises rises after 1973 both in advanced (a) & emerging economies (b) as it had done after 1919

panel (a)

panel (b)

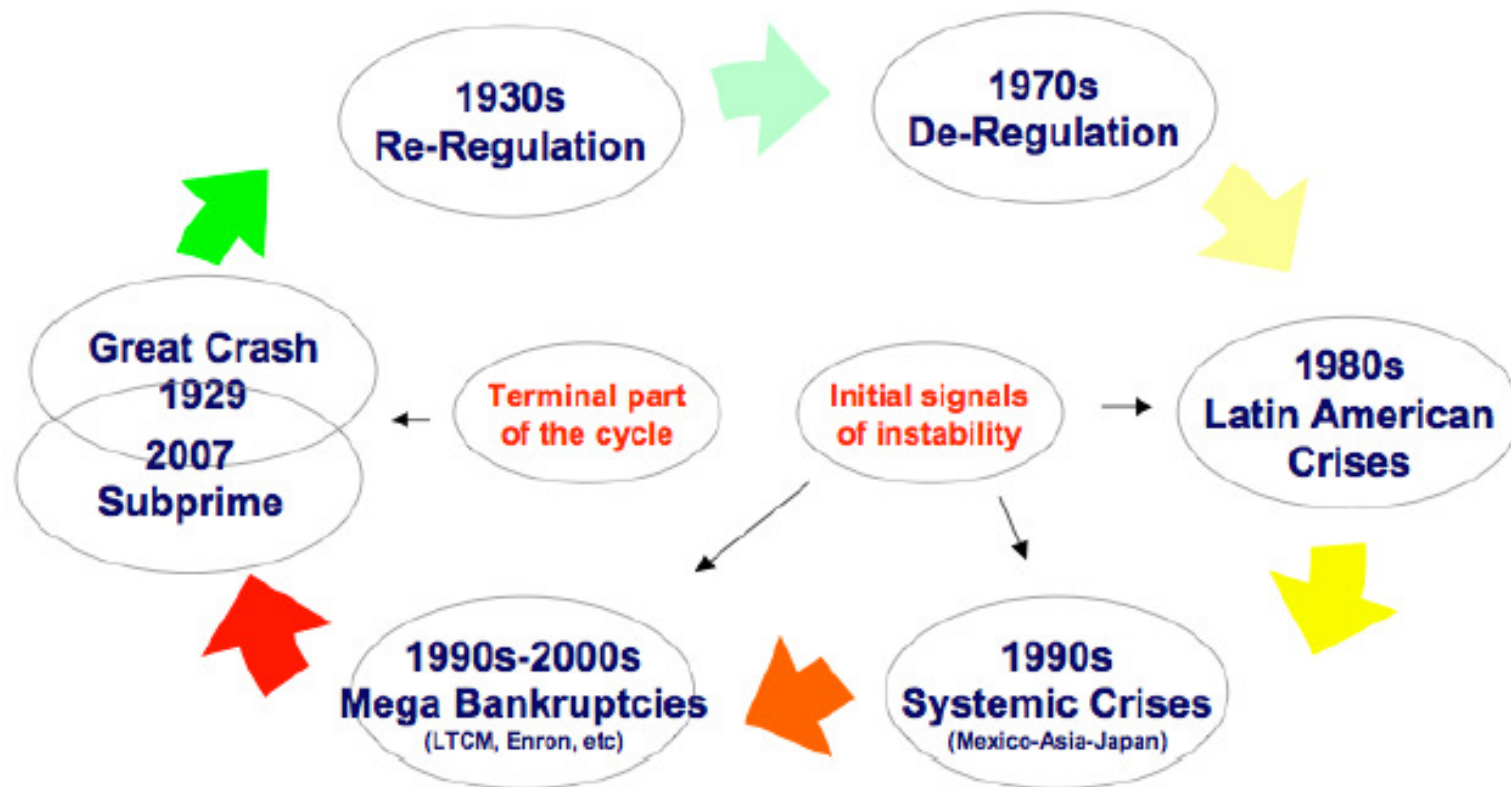
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Is a political economy cycle of finance ending?

- Increasing crises' frequency/depth & calls for re-regulation are suggestive ... but maybe not yet

The Political Economy Cycle of Finance



Is a political economy cycle of finance ending? Cont'd

- Financial crises gradually aggravated hitting the periphery first and then move on to the center of the financial system: *re-regulation is needed*
- Various features of the Great Financial Crisis are analogous to those characterizing systemic financial crises of emerging economies: e.g. financial liberalization, lower credit standards, excessive leverage in the economy, capital inflows of and (possibly) over-valued exchange rate
- The (following) three theoretical/policy errors have made stabilization interventions destabilizing (with Kindelberger: LOLR solves the immediate liquidity problem but heightens moral hazard)

The key theoretical/policy errors behind the crisis - 1

➤ **Questionable risk pricing models from finance**

-The benefits offered by financial markets via diversification have been exaggerated by **underestimating systemic risk.**

-Starting from the base model - e.g. the *Capital Asset Pricing Model* - the assumption is made that sovereign risk is uncorrelated (orthogonal) to private risks.

-Through this the CAPM fundamental formula is derived:

$$ER_i = r + \beta_i(ER^m - r)$$

where ER_i is the equilibrium expected return on risky asset i , r is the risk free rate (approximated by the return on government securities), ER^m is the equilibrium expected return on the diversified portfolio and $\beta_i = \text{cov}(R_i, R^m)/\text{var}(R^m)$.

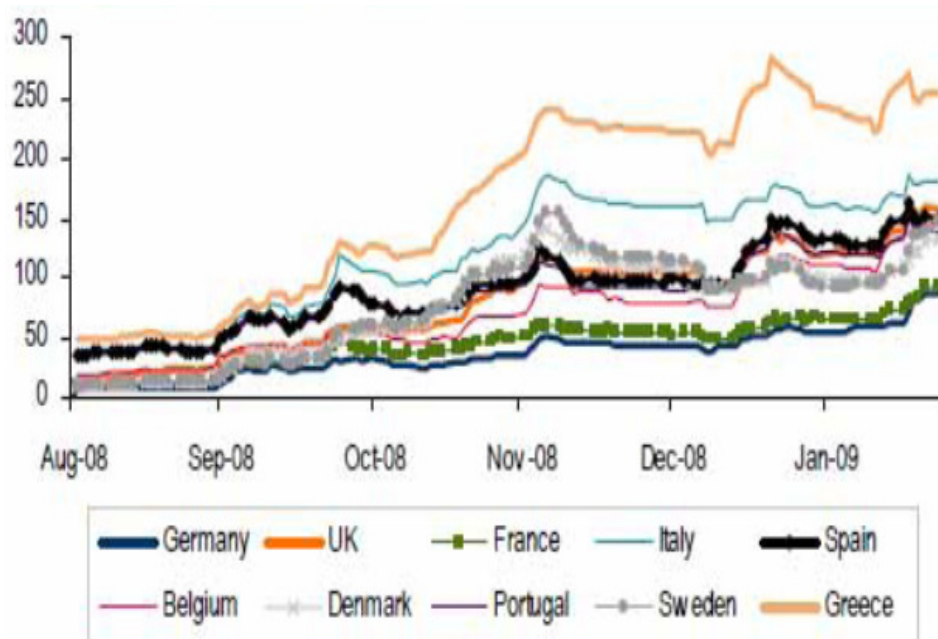
-The fallacy of this assumption of orthogonality of risks has become evident when governments had to intervene to salvage the banks in danger: the spreads on bank CDS lowered while those on sovereign CDS raised (following Fig.

1) ⇒ **risk pricing models need be revised.**

Questionable risk pricing - cont'd [Fig. 1]

Ballooning sovereign CDS

Financial-sovereign CDS spreads
visibly lower after Lehman



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The key theoretical/policy errors behind the crisis - 2

➤ **Wrong 'evolutionary' view of financial system**

➤ The evolutionary view postulated that financial markets be more efficient than banks at managing risk, so that banks should move from the old model (lend & keep the loans, OTH) to the new model (lend & sell the loans, via securitization, OTD)

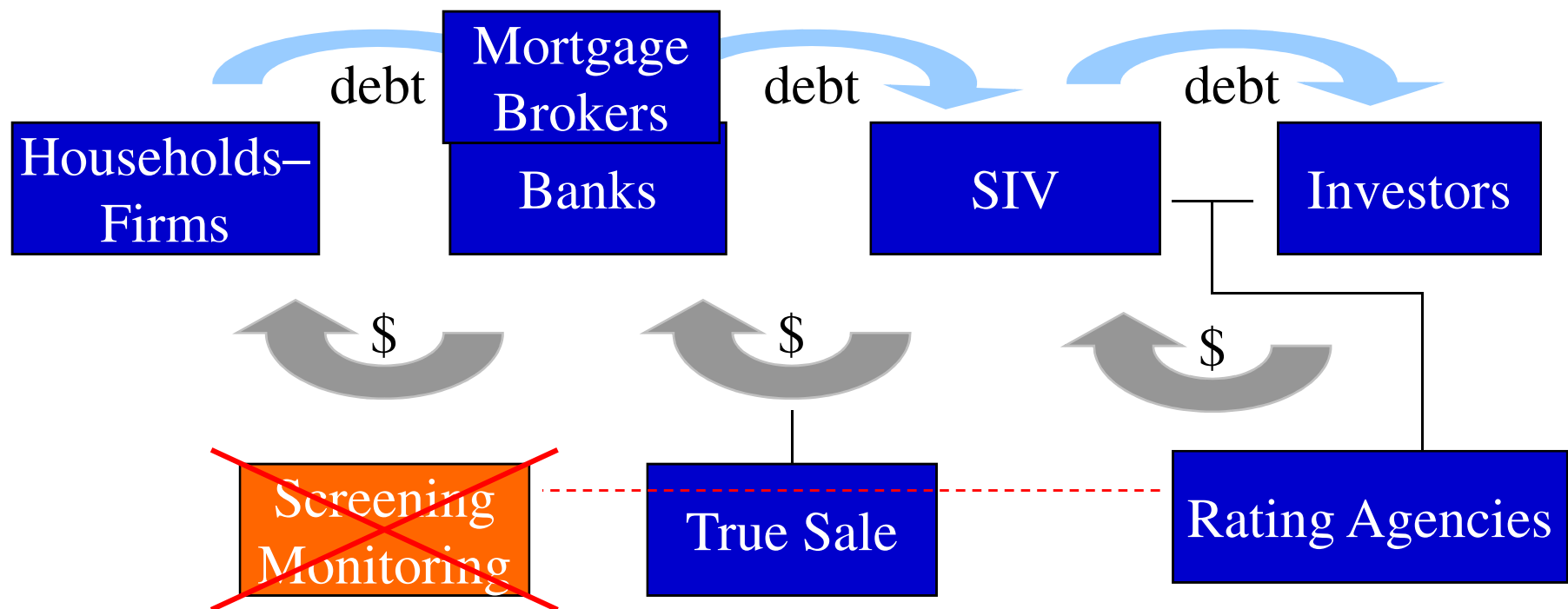
➤ Banks' role as certifiers of loan quality was neglected but that role was there only with OTH not with OTD: granting loans to sell them rather than keep them endangered banks' incentives to perform in depth screening & monitoring of the borrowers (Fig. 2), so that lending standards rapidly deteriorated

➤ And the evaluation of the creditworthiness of the loans underlying securitizations fell back on the rating agencies that founded such evaluation on past historical default rates, but these were based on OTH and, thus, agencies systematically gave overly optimistic ratings

Wrong 'evolutionary' view - cont'd 1 [Fig. 2]

➤ **Securitization & Lenders' Irresponsibility**

➤ From the “*originate to hold*” model to the “*originate to distribute*” model



Wrong 'evolutionary' view - cont'd 2

- For too long we had a **“crossed-eye” theory of finance:**
 - **Market theory** based on complete markets & **perfect information**;
 - **Financial intermediary theory** based on **asymmetric information** & delegated monitoring.

- When, with liberalization, financial markets became dominating banks' practice and even regulatory principles (e.g. IAS, Basel 2) moved toward financial market type activities while weakening banks' credit function ⇒ we **applied to banks the theory** which if adequate to financial markets is **inappropriate to banks**

- It's wrong subordinating banks to financial markets (and also the opposite would be a mistake) ⇒ we need to build on the **banks-markets complementarity** (Allen & Gale, 2000).

The key theoretical/policy errors behind the crisis - 3

➤ **“Impovident” monetary policy by the Fed**

-The mix became explosive when the two previous mistakes – making lenders irresponsible – were compounded with the third: a **monetary policy** focused only on consumer price inflation **which systematically ignored the large global imbalances** that were cumulating [the US current account deficit rose from 1.5% of GDP in 1995 to beyond 6% in 2005-06] and kept **too low interest rates for too long**

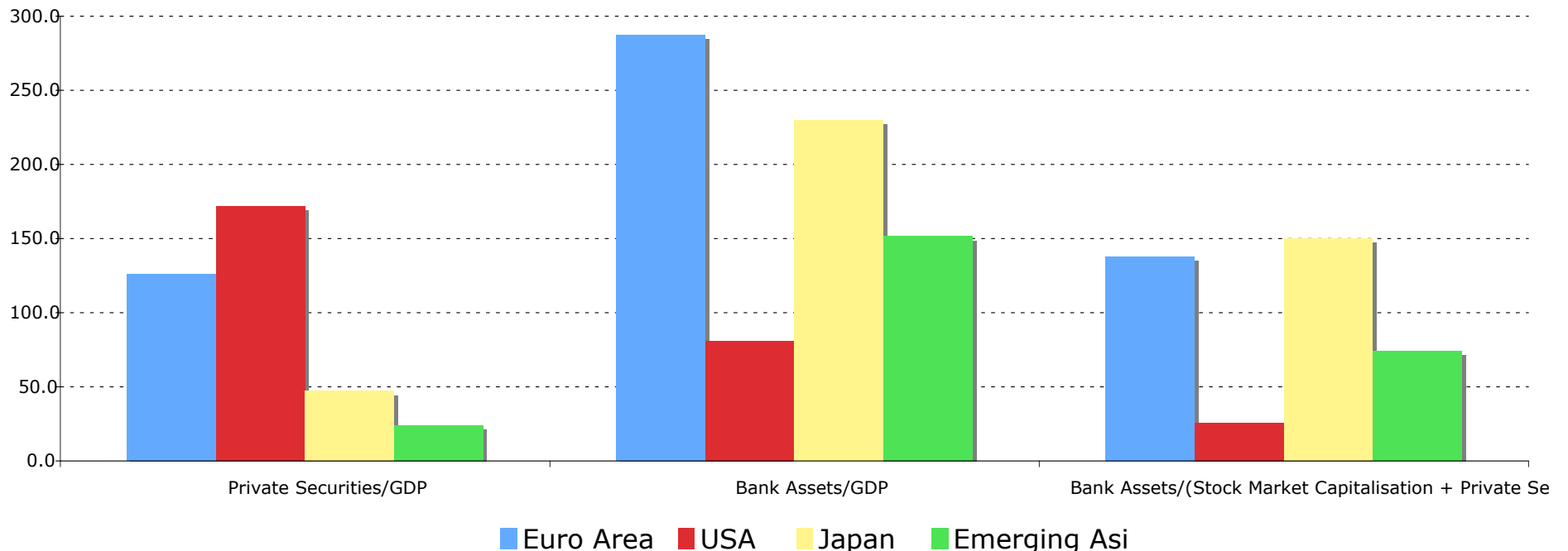
-**As a counterpart** of the external imbalance **US households took on excessive debt** – rising from 71% of GDP in 2000 to 100% in 2007 – mostly against real estate (betting on its continuous appreciation) something that became a nightmare when house prices started falling

➤ Furthermore, **salvaging the LTCM hedge fund** (in 1998) and lowering rates decidedly after the burst of the new economy bubble (in 2000), **the Fed had heightened moral hazard for financial intermediaries**, to the point that pundits described a kind of “*Greenspan put*”, i.e. an option with which if things went well they cashed in the profits and if things went awry the Fed would come to their rescue lowering interest rates

➤ All in all, those **stabilization** policies were **destabilizing** because they were founded on theoretical mistakes

Will Europe and Asia return to Bank-Based Finance?

- EU banks more severely hit than Asian banks
- The financial crisis might lead a return to Bank-Based Finance



- How to preserve financial innovation?

Policies to preserve financial innovation/globalization

- Prospected Financial Reforms go in the right direction:
 - focusing on systemic risk and macroprudential supervision
 - empowering institution with adequate authority/responsibility
 - defining procedures to identify systemic risks sources (e.g. large/interconnected FIs; inadequately regulated shadow banking system; excessive leverage; unregulated OTC markets; cyclical accounting standards/capital regulation; risk-prone compensation schemes; overly optimistic expectations validated by external subjects like the credit rating agencies)
 - proposing ways to tame those risks (stricter regulation/supervision of systemic-threatening FIs; maximum leverage ratios & firewalls where needed; regulation/supervision of hedge funds; regulation/oversight of OTC markets; less-cyclical accounting standards and anti-cyclical capital requirements; longer-term based compensation schemes; requiring originators to retain an economic interest in a material portion of the credit risk of securitised loans; regulation/oversight of the credit rating agencies)

Prospected Financial Reforms - cont'd

- Financial Reforms feature also some differences

Links among the various policy dimensions of the Reforms

	Macroprudential supervision	Microprudential supervision	Regulation	Macroeconomic policies
Macroprudential supervision	–	EU, East Asia, US	EU, East Asia, US	EU, East Asia
Microprudential supervision		–	EU, East Asia, US	–
Regulation			–	EU, East Asia
Macroeconomic policies				–

- The missing links suggest global imbalances/saving glut might be neglected in their interaction with macroprudential and regulatory policies

Would these reforms suffice?

- Reining in systemic risk overall:
 - macroprudential function; assigning it to a specific authority; stricter regulation/supervision of systemic-threatening Fis on a consolidated basis
- Taming systemic risk in important segments of finance:
 - extending regulation/supervision to the hedge funds; regulating and providing oversight on OTC markets
- Abating systemic risk at the individual intermediary's level:
 - maximum leverage ratios & firewalls for financial conglomerates; less-cyclical accounting standards & anti-cyclical capital requirements; longer-term based compensation schemes; requiring originators to retain an economic interest in a material portion of the credit risk of securitised loans
- Lowering systemic risk of individual financial products:
 - regulation/oversight for the credit rating agencies
- Sustainable financial innovation requires that:
 - agents have the right incentives to responsible behaviour;
 - look more at the quality of financial innovation rather than at its quantity.

The role of regional policies

- Regional policies help complement via a bottom-up approach:
 - Chang Mai Initiative;
 - ABMI.
- Further possible general objective is rebalancing East Asia's growth promoting domestic demand growth (especially private consumption), reducing dependence on external demand, and raising employment growth:
 - Improving the social safety net;
 - Further development of financial markets (the basic elements of capital market development and risky financial innovation);
 - Increasing financial inclusion;
 - Accompanying exchange rate policies to allow for more flexible exchange rate regimes in those countries with tightly managed exchange rates

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THANKS FOR YOUR ATTENTION