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Where Do We Go From Here?

Macroprudential Regulatory Policies: The New Road to Financial Stability

13th Annual International Banking Conference

By

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What's the Problem

- Several divergent views of the causes of the financial crisis and skepticism about division between role of central bank in ensuring financial stability v some other body
  - Paul Volcker – proprietary trading and sponsorship of hedge funds and private equity
  - Tommaso Padoa-Schioppa – deconstruction of gold standard and international cooperation and complete distrust of markets
- Problem- Current financial crisis was misdiagnosed as a liquidity problem (liquidity myth) when the issues were solvency and uncertainty about solvency
  - Assert that the key problems were excessive leverage (sometimes in excess of 50 to 1) combined with funding longer term assets with short term liabilities
  - Classic case was AIG – its problems weren't derivatives but rather it had twice as much in losses – about 55 billion in its mortgage and securities portfolio exacerbated by its securities lending program – Borrowed over night to two weeks and bought 5 year MBS
- Another myth is that banks were the major culprits in real estate

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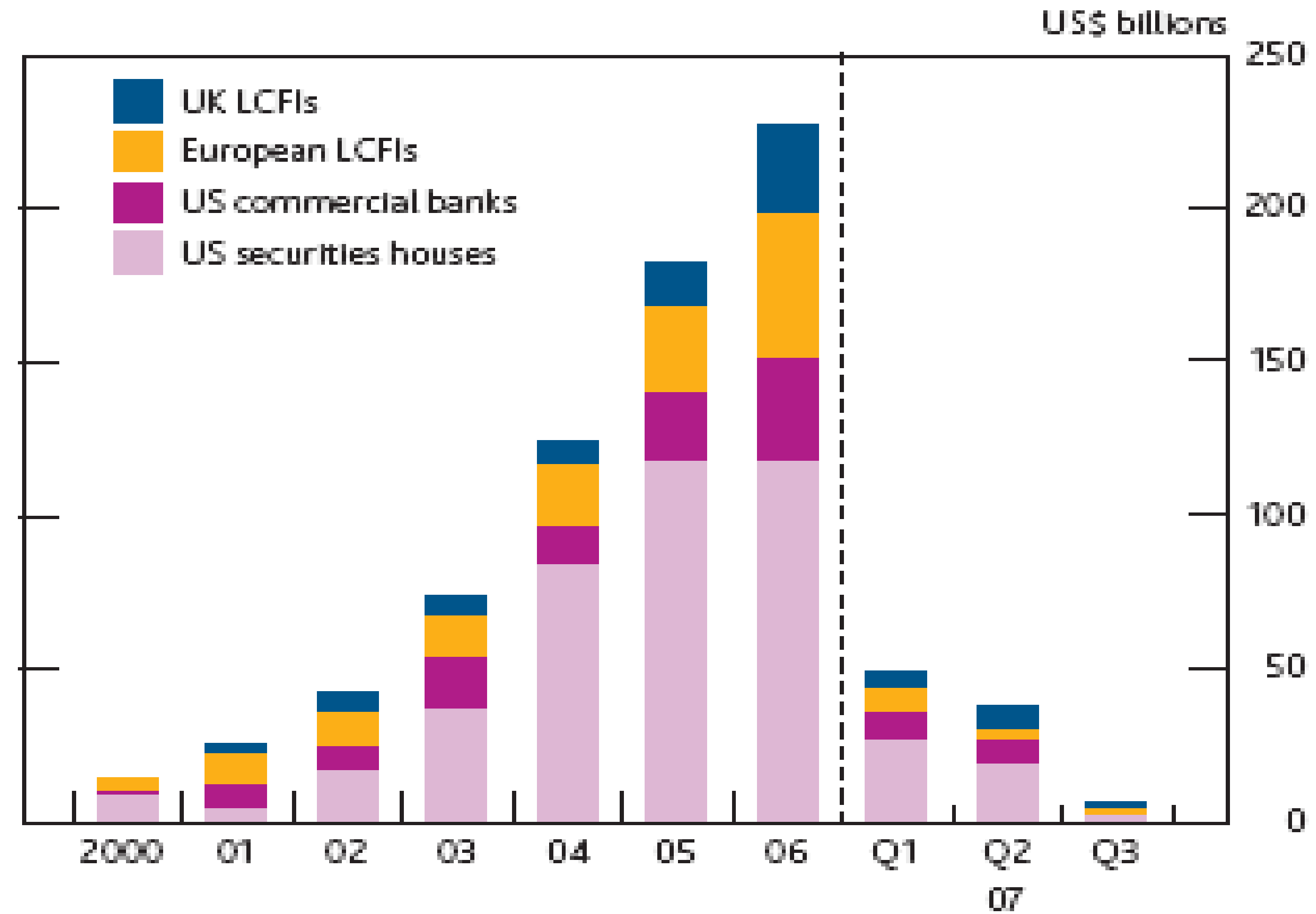
LCFI Issuance of RMBS backed by Sub-Prime Lending – Bank of England Oct. 2007 FS Report



Sources: Dealogic and Bank calculations.

(a) Data include residential mortgage-backed securities (RMBS) backed by sub-prime and non-first lien mortgages.

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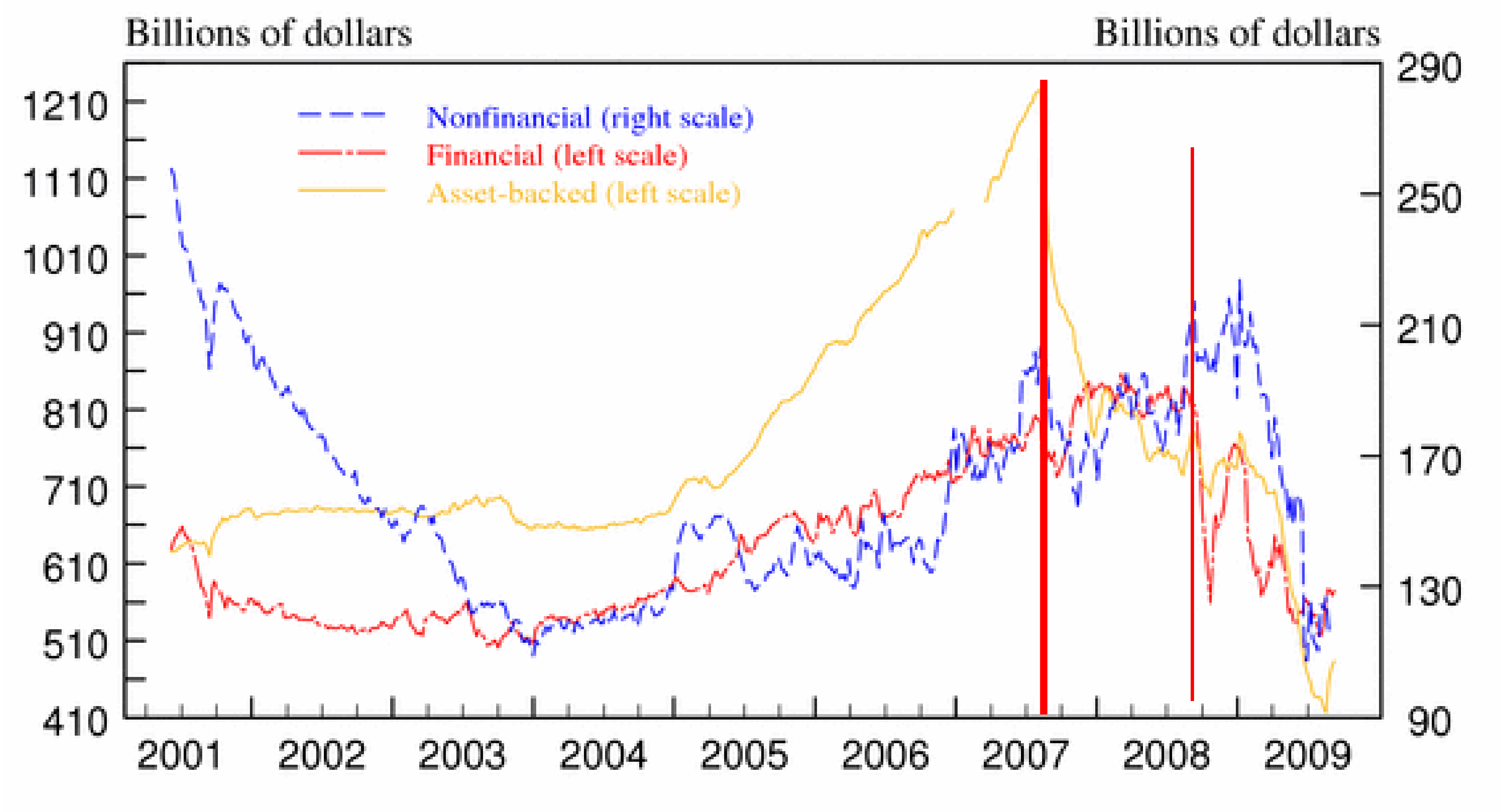
What Has Commercial Paper Done?
Data as of 9/2009



Asset-backed paper fell from $1.2 Trillion to $400 B
Note that financial paper didn't begin to decline until Q4 of 2008
Non-financial paper didn't begin to decline until Q1 of 2009

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TED Spread - 3 Mo. LIBOR less 3 Mo. Tresury Bill Rate
Jan. 2007-August 2007

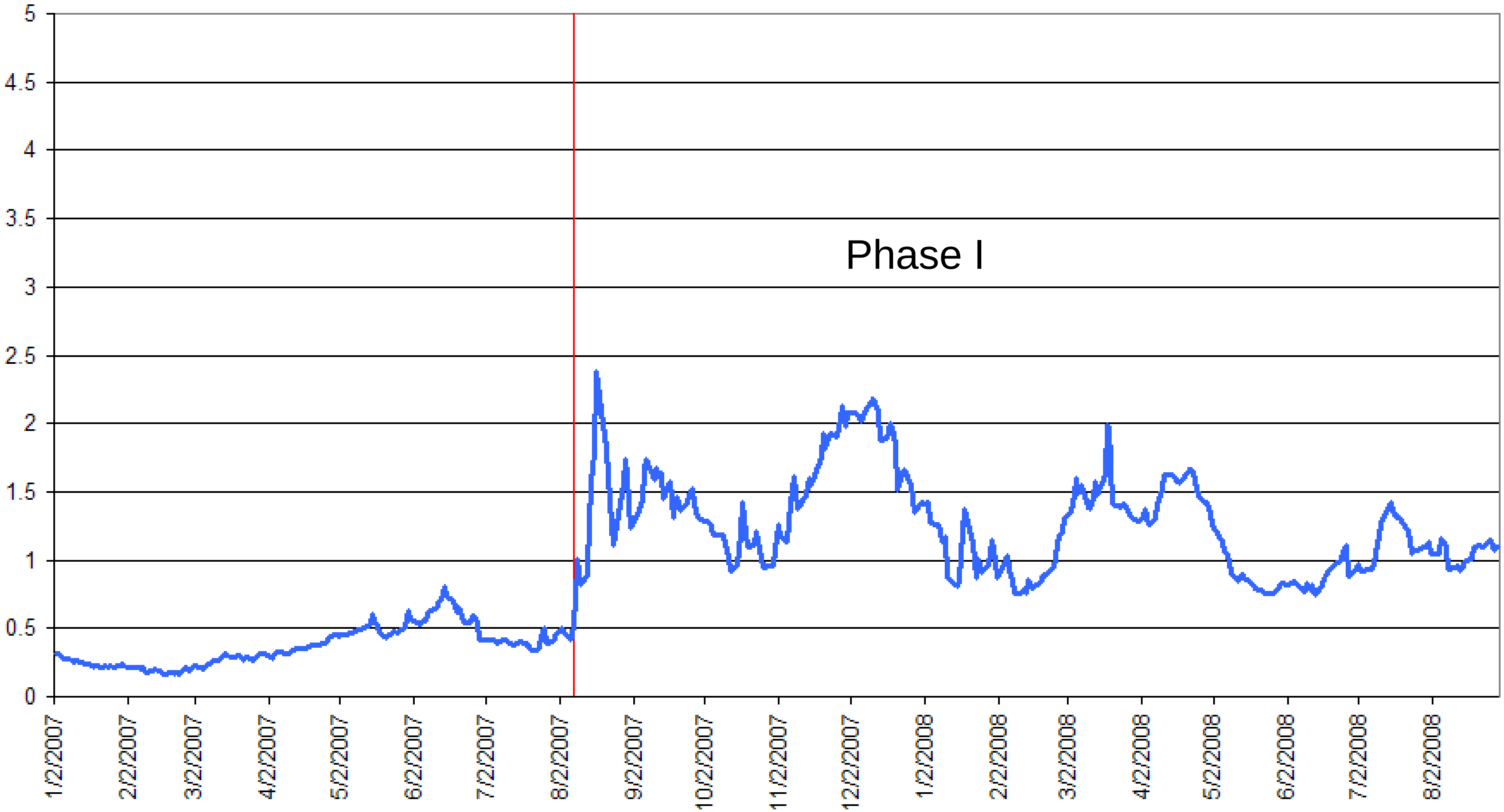
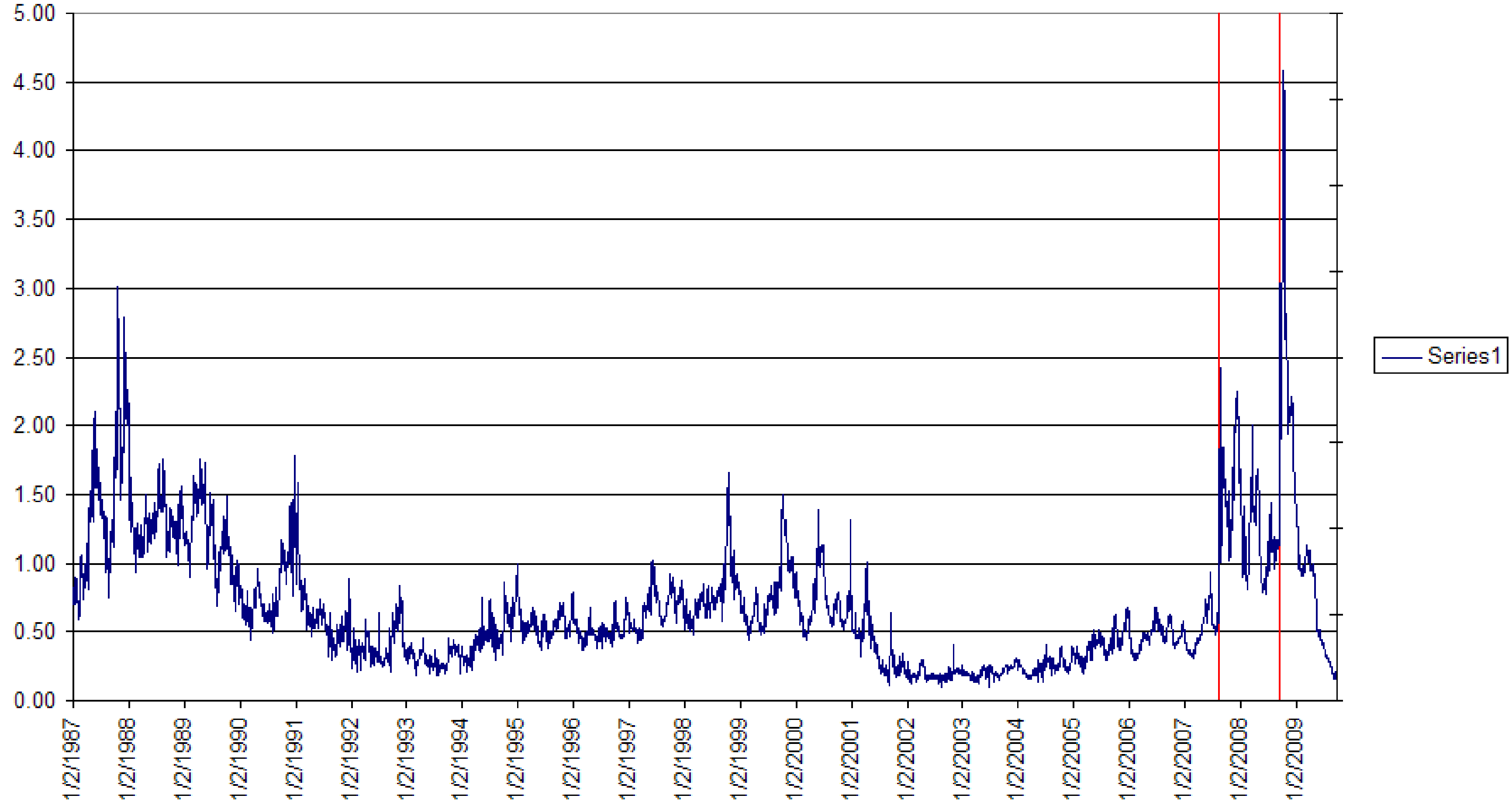


Chart 5

TED Spread - 3 Mo. Libor less 3 Mo. Treasury Bill Rate 1987-Present



World of Lego finance

- Banking firms have struggled to identify a business model –
  - For large banks, the commercial loan business vanished long ago as large corporations gained direct access to capital markets
  - Clearly, the deposit taking/loan making business is giving way to the lego finance risk/management service providing – ie. selling a name
- Ability to sell or rent one's name that is now the key to finance. This in turn depends upon rating and quality
  - Started with bills of exchange and bankers acceptances
- Traditional banking is not something we can hope to return to, but this is exactly the kinds of solutions being proposed
- Kind of intermediation provided by the main institutions involved in the crisis – instead of collecting funds from small depositors and aggregating them into larger loans,
- The large institutions collected small loans and aggregated them into large assets that were funded by gathering large sources of funds from hedge funds and others to fund those large aggregated assets.

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Focus of Academic Research and Remedies

- Use of market prices – but fail to address how, given too-big-to fail market prices can convey meaningful information
- Use of capital regulation – but fail to address adequately the measurement of capital problems
- Pricing of risk via taxation – but fail to address that pricing to achieve desired risk levels from regulatory perspective must know risk return tradeoffs and how decided within the internal corporate governance structure
- Regulation of liquidity– assume that liquidity will be assured by simply having more access to markets and holding more liquid assets without addressing the sources of supply of liquidity and evidence this time that there was a breakdown as markets assessment of risk turned into uncertainty
  - Liquidity depends upon not only quality of collateral but also on their being willing suppliers of funds
  - Raises the Katrina nursing home problem
- Fallacy of the holding company – Walter Wristen – "When your name is on the door, all your capital is on the line – the market demands it."

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Regulation and Reform Should Focus First upon Low Hanging Fruit

- Information sharing
  - Shared national credit program
  - Why didn't European regulators see the exposure to AIG
    - Katrina nursing home problem
- Leverage ratio
- Better integrate PCA with capital requirements -
- Accounting and measurement
- In US get rid of primary dealer system
- Deal with tri-party re-po market issue
- Failure forensics – Lehman report by Bankruptcy Examiner is a model

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Big Problems that May be TOO-Hard

- Too-Big-To-Fail – Why no discussion, especially in Europe of what the exit strategy is now to get rid of government ownership and unlimited guarantees?
- Freddie and Fannie
- Organizational complexity
- Reduce incentives to accommodate and to engage in arbitrage of capital standards – put responsibility on regulators via PCA rather than constraining soundly run institution
- Bankruptcy and national treatment
- Incentives to engage in ring-fencing
- Change willingness to impose losses
  - Dot com bust imposed large losses
  - But when losses are in banks, somehow it becomes too hard
- Dump Basel and micro regulatory management of risk

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