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LOOSE ENDS IN CAPITAL REGULATION: FACING UP TO THE REGULATORY DIALECTIC

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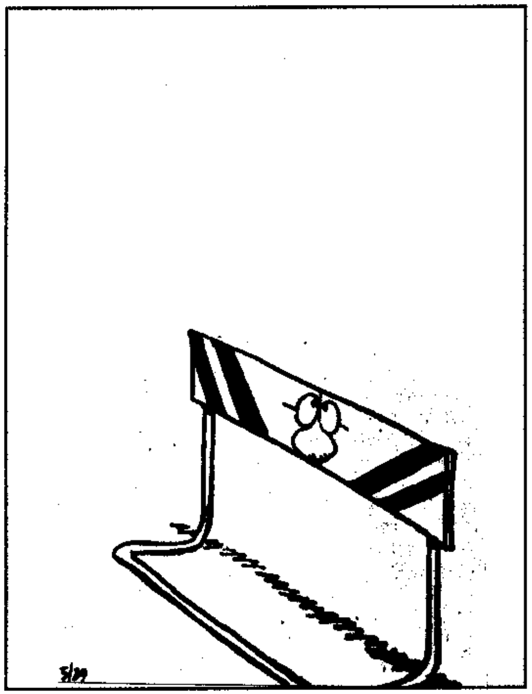
Burdens of Regulation Are Resisted

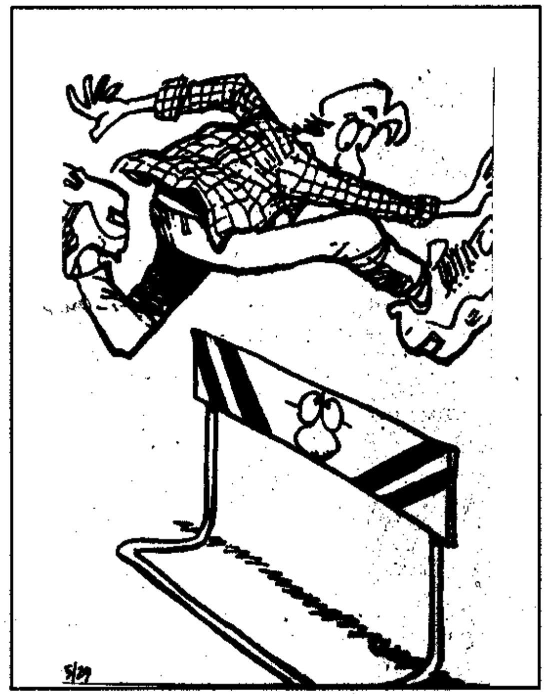
--Looking at regulation from a *Hegelian* perspective dramatizes the incentive conflicts regulators and regulatees face. Loophole Mining and Money Politics Bombard Regulators with Antithetical (i.e., Hegelian) Political & Economic Pressures.

- Regulation = Thesis
- Avoidance and Lobbying= Antithesis
- Re-Regulation = Synthesis (new thesis)

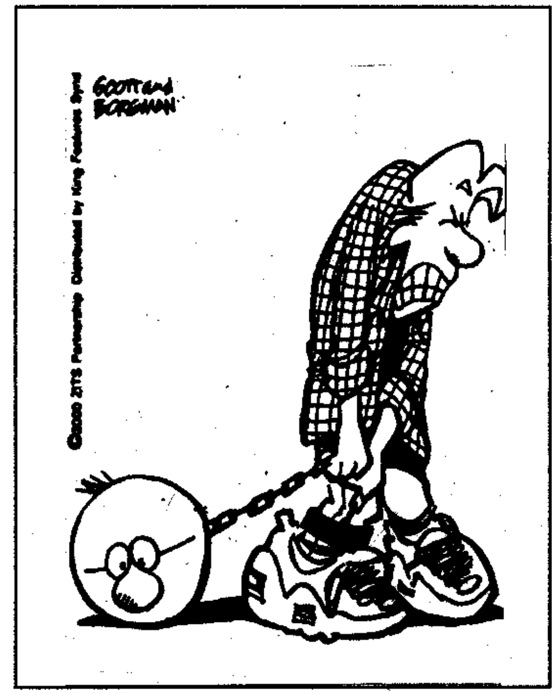
Parent-Child Example



Regulation



Avoidance



Reregulation
(one possibility)

COSTS AND BENEFITS OF REGULATION ARE NOT EXOGENOUS

Bank Accounting and Risk Management resemble a “Makeover” TV Show.

Bankers manufacture their environments. They search out loophole ways to **exercise political clout**, to **adjust & report their asset and funding structures,** and to **choose** the **jurisdictions** in which they book particular pieces of business so as to lower regulatory burdens that government constraints would otherwise put on their pursuit of firm objectives.

Endogeneity of Regulatory Burdens

I view: (1) negotiations in the EU & the Basel Committee on Banking Supervision seeking *global writedowns & risk-based rules* vs. (2)disruptive bank *objections to*-- and *circumvention of*– *rules & contract enforcement* as **conflicting forces** in a dialectical and evolutionary process or game:

- **Regulation** (e.g.,Basel I) immediately begets and subsequently perfects patterns of **Avoidanc**e
- **Avoidance** begets(after a long delay) **Re-Regulation** (Basel II & III), often in response to **Crisis pressures** and **a Credit "Crunch"**
- **Re-Regulation** spawns further rounds of **Avoidance**

INCOMPLETENESS of Basel Accords: No Accountability for Regulators or Credit Raters

Basel Regulations = purported "risk- based" **capital(NW)** requirements on bank loans in major countries (but misperceive & misweight risk). Moreover, Basel II ties risk weights for sovereign debt to ratings, and then permits national authorities to go below those weights for central government (or central-government-guaranteed debt) issued and funded in the currency of the country in question.

The capital requirements directive of the EU made use of that clause and determined that the risk weight for sovereign debt is zero. The newly proposed regulation maintains this provision.

Avoidance=(1)securitizing High-Yield loans in off-balance sheet entities that are falsely labeled **low-risk** and/or (2)**accounting** cosmetically for **loan-loss reserves(“LLR”)**in US and Europe

(Both techniques hide increases in leverage and reputational risk)

Re-Regulation = Haircuts & capital requirements vs. new guarantees for EFSF(worked out with “heads of government :” according to Dallara of IIF)

MY CENTRAL IDEAS

REGULATORY STRATEGIES are Negotiated with the Industry & BURDENS are less substantial than they seem

- It is not the horse that draws the cart, but the oats…Russian Proverb
- Influence-driven incentive conflict is an important phenomenon, but mainstream models of optimal macroeconomic and financial stabilization (e.g., Benigno and Woodford, 2003) studiously ignore it.
- My paper seeks to demonstrate that this modeling failure has helped the financial industry to sow misconceptions, nontransparency, and outright loopholes into the capital standards and regulatory definitions of capital and risk that --then and now-- are supposed to keep financial instability in check.

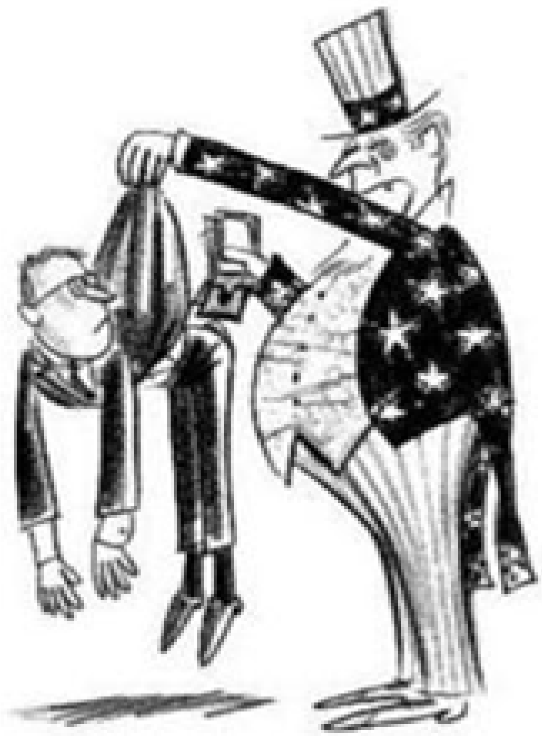
Firms' capacity to hide risk-taking and misrepresent actual losses *open* and *solidify* Loopholes that make lobbyists' disinformational claim that tougher capital requirements will make **banks** pass up profitable, but socially risky credit business seem distressingly dishonest.

The crisis underscores two lessons that US & EU regulators refuse to confront . **Accounting** ratios are not **difficult to overstate** and bankers do not **accept** high statutory burdens **passively.** Higher capital requirements incentivize banks to raise risk profiles, under-reserve for exposures, and conceal emerging losses so as to minimize adverse effects on bank profits and stock prices.

Unlike Macroeconomists, Bankers understand the financial safety net –*not* as something external to their economic balance sheet—but as a politically enforceable *implicit contract* that they have negotiated with national governments. This contract allows governments to impose capital requirements in exchange for committing itself to bail out large portions of the financial industry in crisis circumstances.

But it is a sucker's game to let requirements be as complex and politically driven as those in Basel. The absence of cross-country accountability for individual-country rules and enforcement allows effects of increased capital requirements on the taxpayer put to be neutralized by political influence (contributions & the "revolving door") and by creative ways of reframing financial-institution risk taking.

A "TAXPAYER PUT" UNDERLIES CRISIS-MANAGEMENT STRATEGY IN US AND EUROPE



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Lobbying Leads to Capital Forbearance

Lobbyists create a "taxpayer put" by cultivating among politicians and regulators an excessive fear of letting banks' **accounting decisions** or **health** be called into **question: The M-A-D bluff**

Without the taxpayer put, Creditors of a weak bank would face haircuts and excessively risky banks would have risk retrenchment forced on them by market and regulatory discipline.

Disciplinary Pressure leads a firm to "crunch credit," but so does forbearance. *Indiscriminate Bailouts* are the opposite of discipline.– They tempt zombie firms (e.g., AIG) to eschew *productive* lending programs in favor of reaching our for yield: i.e.,"gambling for resurrection."

A Credit Crunch Occurs When Banks See “Better” Uses for their Funds

Differences in Costs of Loophole Mining Can Explain Why the Current Crisis Proved Most Severe in Financial Centers and Other High-Income Countries

1. During the bubble in securitized credit, Banks in High-Income Countries faced **low avoidance costs:** [Creditors allowed them **great accounting leeway** and they could transact in a rich **array of nontransparent instruments** at low trading costs with little negative feedback from customers, regulators, or politicians.]
2. Over time, the gap between **desired ratios** and effective **legal minima** fell in all countries and the **threshold** of per-capita GDP a country's banks needed **for effective burden avoidance** fell as well. [For two reasons: (1) trading costs declined as derivative markets proliferated, and (2) loopholes in regulatory and accounting structures became better defined.]
3. In the crisis, the **surge in nonperforming loans** simultaneously increased market discipline and panicked regulators. Conceptual Poverty of Basel's Risk-weighted capital approach became obvious. Basel ratios **did not predict** bank health or the need to restrain zombie-bank gambling for resurrection.

REGULATION CAN BE LIKENED TO MEDICINE

- Therapeutic Treatments are bundles of good and bad side effects. Although there is sometimes a “golden moment,” therapies seldom prove beneficial for all *intervals of time* or for all *types of patients*. Goal is to create net value for patients and society through time.

- So it is with capital regulation. To evaluate regulatory treatments properly, one must worry about both the *adequacy of the diagnosis* of the difficulties regulators seek to correct and the *limitations of the therapy they prescribe.*

- In the laboratories in which global regulatory strategies are crafted today (Basel & Brussels), the diagnosis that “doctors” are pursuing is that financial crises require blanket guarantees, but can be avoided by aligning a firm’s “perceived” leverage with its “perceived” risk: i.e., by setting and enforcing so-called risk- sensitive "capital requirements” in hopes of raising the equilibrium ratio of *accounting net worth* to total assets at risky financial firms. **As if a bank with more capital always safer than a bank with less???!**

CONTRARY HYPOTHESES SUPPORTED BY RESEARCH:

1. Financial crises are **inevitable**. Every country's financial sector passes through a succession of three-stage sequences: a pre-crisis bubble in credit, an actual crisis, and a post-crisis period of healthy recovery.

2. Risk and Net Worth are hard to measure and standards for aligning them are hard to set and enforce. Banks have an incentive to hide & understate their Risk, overstate their Net Worth, and to lobby against appropriate standards.

Genuine repair would have to begin by REFRAMING THE POLICY PROBLEM that Basel and Brussels are Supposed to Solve. Here is a Headline we might hope for:

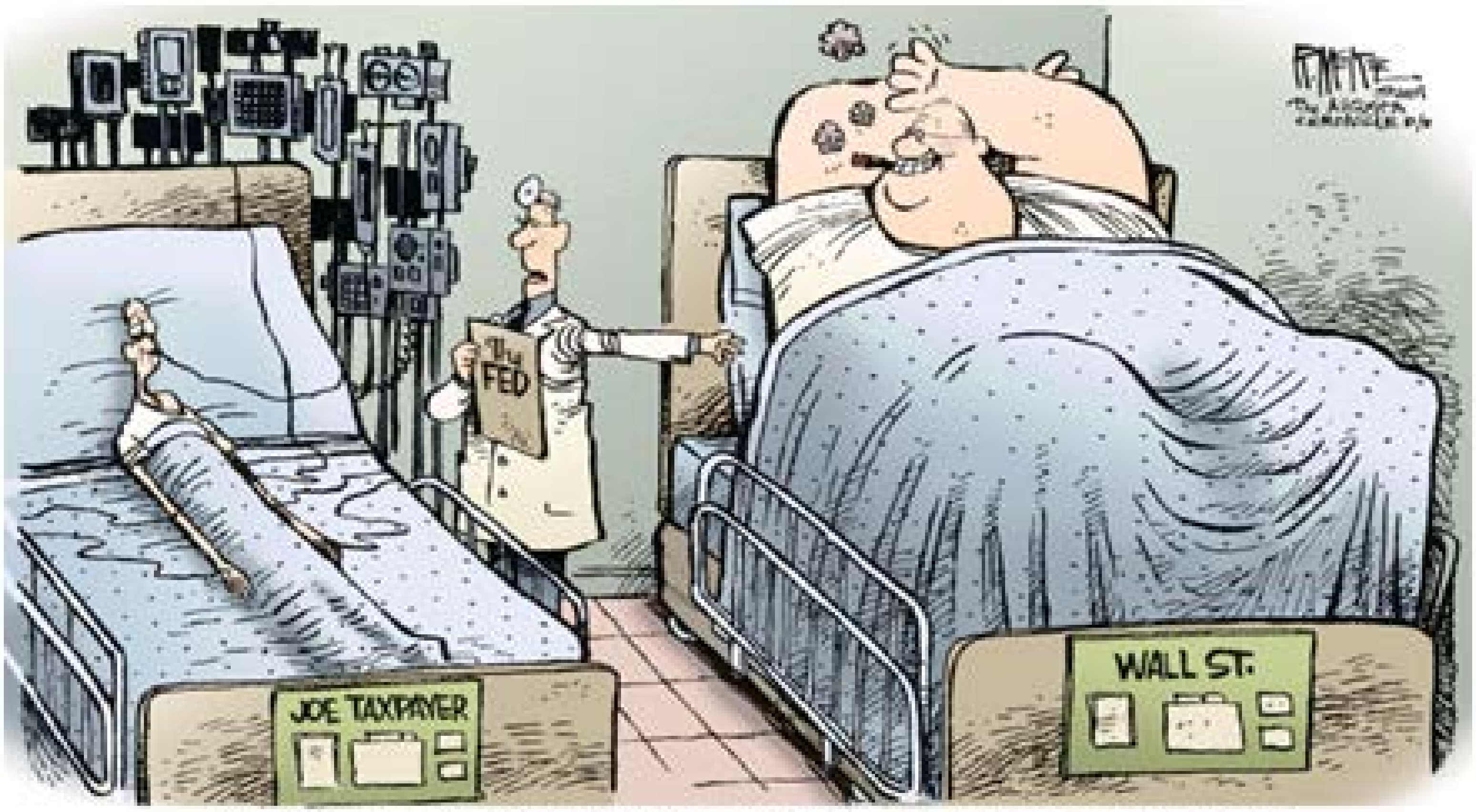
The thing that came loose is TRUST. Higher Capital is no silver-bullet repair. Society Needs to Incentivize and Monitor Private and Public Managers of National Safety Nets So that INCENTIVE DILEMMAS DO NOT Subsidize Firms that actively Expand Their Risk-Taking and Political Clout in Destructive Ways.

Long-run Remedy: A cocktail of incentive adjustments. Government Officials and managers of protected institutions should be made at least as **accountable to taxpayers** for measuring and honestly disclosing the equity-like loss exposures that they shift to taxpayers as corporate managers are accountable for disclosing value of operations to stockholders.

- Repair Ethics of Finance and Credit-Rating Process: Genuine Reform Would create Accountability for Suppressing Information about Tradeoffs officials make between Fairness to Taxpayers and Other Objectives

A critical step must be to strengthen training and recruitment procedures for top regulators. Incentive conflict is the problem and placing political patronage at the center of the appointment process amplifies incentive conflict. One's ability to handle incentive conflict is shaped in large part by one's personal sense of honor and duty. In many areas of public service, a candidate’s sense of honor and duty is honed by specialized training programs. I believe that the US needs to establish a specialized academy for training financial regulators and admit cadets from around the world. This would forge connections between graduates at supervisory agencies in different countries and pave the way for more-effective information flows and cross-border regulatory cooperation. Besides studying principles of financial engineering, students would be drilled in the duties they owe the citizenry and in how to overcome the political pressures that elite institutions exert when and as they become undercapitalized.

A GOOD BEGINNING: SHIFT THE FOCUS OF RESCUE POLICIES TO SOCIETY AS A WHOLE



"I DON'T WANT TO ALARM YOU, BUT IF YOU DON'T GIVE THIS MAN a TRANSFUSION RIGHT NOW, YOU COULD DIE."

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WHAT MIGHT CITIZENS DO TO MAKE THIS HAPPEN?

1. DEMAND THAT CENTRAL BANKS AND OTHER REGULATORS HERE AND ABROAD DOCUMENT HOW THEIR STRATEGIES FOR PRESERVING FINANCIAL STABILITY ARE SUPPOSED TO WORK AND HOW THEY WILL AFFECT TAXPAYERS IN DIFFERENT COUNTRIES

2. DEMAND TRIAGE: PRESS POLS TO ASK REGULATORS TO BEGIN TO EXERCISE RESOLUTION AUTHORITY

A. BY ANNOUNCING PROGRAMS FOR TEMPORARILY NATIONALIZING ZOMBIE FIRMS LIKE FANNIE, FREDDIE, BANK OF AMERICA, AND CITIGROUP AND TAKING STEPS TOWARD PUTTING THESE PROGRAMS IN ACTION

B. EFFECTIVE PROGRAMS WOULD HAVE POWER TO REPLACE TOP MANAGERS, ELIMINATE PROFIT-DRIVEN BONUSES, AND BREAK UP & REPRIVATIZE INTELLIGIBLE SEGMENTS OF EACH OF THESE FIRMS

None of This Will Happen Without Taxpayer Awareness and Political Force

10-13-11 THE PHILADELPHIA INQUIRER. UNIVERSAL UCLICK.