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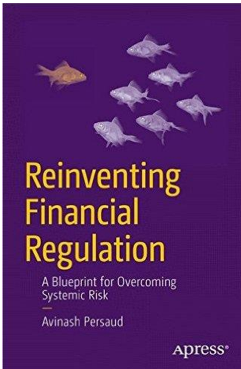

REINVENTING FINANCIAL REGULATION: A BLUEPRINT FOR OVERCOMING SYSTEMIC RISK

Author: Avinash Persaud
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The 2008 global financial crisis has sparked widespread debate amongst economists, regulatory bodies, standard setters and market participants in relation to one fundamental question: Why did microprudential regulation[1] fail to predict and restrict the crisis? The book "Reinventing Financial Regulation: A Blueprint for Overcoming Systemic Risk" by Avinash Persaud seeks to address this question as well as prescribe a more effective form of financial regulation. This is a timely discussion, as the retrospective assessment of past failures, should inform regulatory reform, which is forward looking in its attempts to address both known and emerging risks in the financial system. Therefore, this book would be ideal for policy makers. The author draws on his extensive knowledge of financial markets, previous bodies of work and experience to support his arguments, which is evident in the anecdotes used to inform the discussion.

The discussion is divided into three main sections. Section I (chapters 1-2), provides the relevant background and underpins the imporatance of financial regulation. The limitations of the current regulatory regime are discussed in section II (chapters 3-4). In section III (chapters 5-14), the author outlines and develops his proposals for regulatory reform, offering a critical assesement of its viability.

Using past financial crashes, such as the Asian Financial Crisis 1997[2] and the more recent global financial crisis as a backdrop, the author begins his argument by illustrating the need for

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[1] Microprudential regulation refers to the incumbent regulations that focus on limiting risk-taking behaviour of individual financial institutions to protect consumers (Zhou 2010).

[2] Foreign-exchange crisis caused by a credit crunch (foreign funding), which led to the collapse of the currency in Asian countries in 1997 (Goldstein 1998).

financial regulation. The breakdown of the Bretton Woods system[3] in 1971, as well as the financial crises in the decades to follow, are prime examples that the financial system cannot be left to its own devices. Although markets are somewhat self-correcting, the author's critique and the wider literature prove that there is a need for some level of financial oversight and control. Moreover, financial instability can lead to extensive economic, financial and social costs. The Asian Financial crisis sparked political instability that was plagued by riots, violence and eventually forced the resignation of President Suharto (see Haggard 2008). Although, political unrest was not as prevalent in the 2008 global financial crisis, politicians in the US were condemned for the large volume of bailouts and cuts to public expenditure. In these examples, the loss of output (GDP) was also severe.

While underscoring the role of regulation, the author criticises the foundation of the current banking regulation regime, which he characterises as having three main pillars. The first pillar relates to the central bank's role as the lender of last resort. While highlighting the effectiveness of this activity, the unfavourable market reaction that can arise when news of a bank using this facility breaks, can threaten financial stability. The next pillar is the use of deposit insurance, which typically offers insurance up to a certain limit. As seen in the recent global financial crisis, and after the great crash of 1929, the failure of a banking institution can also lead to system-wide deposit runs as depositors may consider the insurance coverage to be insufficient[4]. It is important to note that these two pillars criticised by the author are key components of crisis management. The last pillar is the mandate of consumer protection. Although, microprudential regulation seeks to ensure that individual institutions are operating prudently and are well capitalised against risk estimates to protect depositors and investors, it does not account for systemic risk. The author refers to the method used to estimate capital adequacy in this case as the risk sensitivity approach. Like many regulators, market participants and researchers, Persaud criticises the accuracy, adequacy and comparability of its calculations (see Leslé and Avramova 2012). The risk sensitivity approach ensures firms set aside risk-weighted capital against activity perceived as risky. However, it is when those products considered safe become risky that accounting and risk based standards create systemic risk, as institutions try to offload these assets (chapter 8). In the recent financial crisis, mark-to-market[5] accounting exacerbated the situation as financial institutions had to raise capital through fire sales to offset the deterioration in their asset/liability ratio caused by the steep fall in market prices. This led to increase computed risk which also required more capital. A consequence of this has been central banks moving from lender of last resort to buyer of last resort for the markets. The author argues that is a difficult task to undertake. Moreover, according to Persaud (2008), mark-to-funding[6] is a more appropriate accounting model for institutions with long-term loans and long term-funding.

After the collapse of Lehman Brothers in 2008[7], politicians argued that over-the-counter (OTC)[8] transactions should be banned. However, the author rightly opposes this view as there is a need

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[3] The Bretton Woods System was the monetary regime implemented to promote monetary stability during 1946-1970. Persaud defines a main feature of the Bretton Woods international monetary system as the obligation for each country to adopt a monetary policy that maintained its exchange rate parity to the US dollar.

[4] After the collapse of the investment bank Lehman Brothers in 2008, the deposit coverage limit in the USA was increased to $250,000 on October 3, 2008 in an effort to minimise bank runs.

[5] Mark-to-market accounting refers to the valuing of assets at their current market price.

[6] Mark-to-funding accounting refers to the valuing of assets based on the institutions need for the funds.

[7] Lehman Brothers was heavily concentrated in the OTC derivatives market (approximately $400 billion).

for OTC markets that accommodate larger scale transactions than those that tend to trade on exchange markets. Instead, emphasis should be placed on removing the incentive for bankers seeking high bonuses through quick gambles, by introducing a compensation cap. He goes on to say that while satisfying, imprisoning bankers will not solve the problem as crashes are caused by the connivance of many and seldom the connivance of one[9]. Therefore, there must be a change in the incentives to promote sustainable behavior. The bankruptcy of Barings[10] in 1995 and losses of Allied Irish Bank (AIB)[11] are just a few examples that bankers' misconduct can play a role in creating risk, including reputational risk. Hence, Persaud makes a valuable argument for the realignment of incentives.

In Chapter 5, the author begins the discussion on reimagining financial regulation by briefly evaluating the popular concept of macroprudential regulation[12]. Its top-down approach to assessing systemic risk is more accurate in predicting financial instability than the risk aggregated (bottom-up) approach under microprudential supervision (see Borio 2003). Though, this form of regulation also relies on risk-weights that can be calculated inaccurately, the author endorses the concept of countercyclical measures to address the boom/bust phases of the financial cycle used under this policy, and the need to codify these measures in order to limit political and emotional influence is highlighted. Though the latter is important in ensuring the willingness of policy makers to act, countercyclical buffers require regular evaluation and adjustment, and are not always immune to the financial cycle. Therefore, this may not be an appropriate or effective measure for all financial systems in my opinion.

The author's main argument on regulatory reform is the notion of risk-absorptive capacity. In chapter 6, the author skillfully illustrates that financial firms have the capacity to hedge against one or more types of risk, through an analogy between a bank, life insurer and pension fund. The scenario shows how a bank with short-term funding, and loans to a diversified client base with appropriate credit risk premiums, has the capacity to absorb credit risk but not liquidity and market risk. On the other hand, life insurers and young pension funds have a better risk capacity for liquidity and market risk, which are better hedged by time, but are not well suited to absorb credit risk. Therefore, he makes the point that banks should sell high quality credits and low liquidity assets to insurers and young pension funds, and buy low quality credit, hence transferring the risk it does not have the capacity to absorb and keeping the risk it does. This alignment of risk and risk capacity would help to limit systemic risk. He goes on to add that another advantage of placing risk where it can naturally be absorbed is that there is less dependency on risk estimations, which are proven to have limitations under the current risk-weighted framework. To treat any shortfall risk expected from this approach, capital and reserve requirements would then be adjusted. Therefore, the author asserts that this method will capture most of the risk in the system and not just transfer it to a place where it is undetected.

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[8] OTC derivatives are over-the-phone trades done directly between two parties as opposed to through an exchange market. Therefore, the terms of the contract do not have to be specified in accordance with the requirements of the exchange. (FRM 2013)

[9] Avinash Persaud, Imperial Business Insights series at Imperial Collage Business School, September 14th, 2015.

[10] Barings made losses of over $1 billion due to the unauthorised trading of a Nick Leeson who misreported his losses to earn high bonuses.

[11] AIB realised approximately $700 million in losses after John Rusnak, a currency option trader, conducted large unauthorised foreign exchange trades between 1997 and 2002 and used deep-in-the-money options to hide his losses.

[12] Macroprudential regulation aims to limit the risk of episodes of financial distress with significant losses in terms of the real output for the economy as a whole (Borio 2003).

In essence, the book offers a fresh and useful perspective on financial regulation, hinged on regulation moving from a focus on risk sensitivity to one on risk-absorptive capacity. It provides a valuable contribution to its field and the ideas put forward can be used by policy makers, regulators and standard setters in informing future financial regulatory reform and research. The scope for risk-absorptive capacity in the Caribbean can also be further examined to determine its applicability and usefulness for such small open economies.

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