

## The debate on banking regulation

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The financial meltdown triggered by the sub-prime mortgage crisis has changed the terms of the debate over financial regulation, offering an opportunity for major, even radical, reform. We can, therefore, think of elements of a new regulatory structure that goes beyond what seemed feasible thus far. This note discusses certain directions in which we can hope to go, using as its point of departure the kind of regulatory structure that the Basel framework implied and the problem with that structure as illustrated by the ongoing financial crisis.

At the centre of the Basel framework was a set of beliefs on how financial markets functioned and therefore should be regulated. The first was that if norms with regard to accounting standards and disclosure were adhered to, capital provisioning, in the form of an 8 (or more) per cent capital adequacy ratio, was an adequate means of insuring against financial failure. Second, this was to be ensured by requiring that the size of regulatory capital was computed not on the actual value of assets but on a risk-weighted proxy of that value, where risk was assessed either by rating agencies or by the banks themselves. Risk-weighting was expected to rein in risk taking as it would inflate the size of regulatory capital required as the share of more risky assets in the portfolio of banks rises, discouraging banks from holding too much of such assets because that would lock up capital in forms that were near-barren. Third, this whole system was to be made even more secure by allowing the market to generate instruments that helped, spread, insure or hedge against risks. These included derivatives of various kinds. Fourth, use of the framework was seen as a way of separating out segments of the financial system that should be protected from excessive risk (for example, banks, in which depositors trusted their money) and those where sections which could be allowed to speculate (high net worth individuals) can legitimately do so (through hedge funds, private equity firms, and even investment banks)

Implicit in these beliefs was the idea that markets, institutions, instruments, indices and norms could be designed such that the financial system could regulate itself, getting off its back agencies that imposed structural and behavioural constraints to ensure the “soundness” of the financial system. The intervention of such agencies was seen as inimical to financial innovation and efficient provisioning of financial services. There was an element of systemic moral hazard involved here. If the system is seen as designed to self-regulate and is believed to be capable of self-regulation, then any evidence of speculation would be discounted. In fact, it would be seen as a legitimate opportunity for profit, leading to responses that reinforce such speculation.

The collapse or near-collapse of banking institutions in the US and UK in the course of the financial crisis raised not just the question of the appropriate form of ownership in the banking sector, but questioned the form that banking structures, banking strategy and banking regulation took in the US and UK. From a developing country perspective this is of considerable significance because financial liberalization and reform in developing countries has been geared to homogenize financial systems and restructure the still-dominant banking sectors in these countries to approximate the “model” that emerged and came to prevail in the Anglo-Saxon world since the late 1980s. The failure of the Anglo-Saxon model is now seen as indicative of the fact that a number of features of that system which governments and regulators in the developing world had chosen to move towards have lost their legitimacy.

As opposed to the rhetoric regarding the efficiency, transparency and robustness of financial markets in the US and UK, the “real” Anglo-Saxon model has proved to be the imperfect, crisis prone system that emerged and consolidated itself after the 1980s. Prior to that banking in the US was highly regulated and shaped by the Glass-Steagall Act of 1933. Regulation of this kind was necessitated by the crisis that engulfed the free banking regime that characterized the US in the early 20th century. During 1930-32 alone, more than 5000 commercial banks accounting for about a fifth of all banking institutions in the US suspended operations and in many cases subsequently failed.

As is well known, the regulatory framework that Glass-Steagall defined (and served the US well for more than four decades) was designed to protect banks against failure by excluding them from competition of a kind that forces them to adopt risky strategies in search of larger business volumes and higher margins. Underlying the 1930s crisis was the competition that characterized the free banking era in which interest rate competition to attract deposits necessitated, in turn, investment in risky, high-return areas. This soon showed up in a high degree of financial fragility and almost routine bank closures. The Banking Act of 1933 limited competition with deposit insurance, interest rate regulation, and entry barriers which together rendered any bank as good as any other in the eyes of the ordinary depositor. This preempted the tendency to push up deposit rates to attract depositors that would require risky lending and investment to match returns with costs. The regulatory framework went even further to curb risky practices in the banking industry. Restrictions were imposed on investments that banks or their affiliates could make, limiting their activities to provision of loans and purchases of government securities. There was a ban on banks underwriting securities and serving as insurance underwriters or agents, besides limits on outstanding exposure to a single borrower and lending to sensitive sectors like real estate. Finally, solvency regulation involved periodic examination of bank financial records and informal guidelines relating to the ratio of shareholder capital to total assets. Central to the scheme of regulation was the view that given its role the banking system has to be excluded from activities and positions that involved anything more than a minimal level of risk.

There were two consequences of this structure of regulation. First, even though this regulatory framework was directed at and imposed principally on the banking sector, it implicitly regulated the non-bank financial sector as well. It is not often recognized that the size, degree of diversification and level of activity of the non-bank financial sector depends on the degree to which institutions in that sector can leverage their activity with credit delivered directly or indirectly from the banking system. Banks being the principal depository institutions are the first port of call for a nation’s savings. So if direct or indirect bank involvement in a range of non-bank financial activities was prohibited, as was true under Glass-Steagall, then the range and scope of those activities are bound to be limited. Not surprisingly, right through the period of intensive regulation of the financial sector in the US, there was little financial “innovation” in terms of new institutions or instruments, though there were periods characterized by substantial and rapid growth in the financial sector. In the event, even by the 1950s, banking activity constituted 80-90 per cent of that in the financial sector. And even at the end of the 1950s, savings accumulated in pension and mutual funds were small and trading on the New York Stock Exchange involved a daily average of three million shares at its peak as compared with as much as 160 million shares per day during the second half of the 1980s, when leverage became possible. In sum, regulation involved intervention that influenced the financial structure.

A second consequence of the regulatory structure epitomised by Glass -Steagall was the implicit decree that banks would earn a relatively small rate of return defined largely by the net interest margin, or the difference between regulated deposit and lending rates adjusted for intermediation costs. Thus, in 1986 in the US, the reported return on assets for all commercial banks with assets of \$500 million or more averaged about 0.7 per cent, with the average even for high-performance banks amounting to merely 1.4 per cent. The net interest margin (to earning assets) was 5.2 per cent for the high performance banks (Gup and Walter 1991). This outcome of the regulatory structure was, however, in conflict with the fact that these banks were privately owned. What Glass-Steagall was saying was that because the role of the banks was so important for capitalism they had to be regulated in a fashion where, even though they were privately owned and socially important, they would earn less profit than other institutions in the financial sector and private institutions outside the financial sector.

This amounted to a deep inner contradiction in the system which set up pressures for deregulation. What is clear in hindsight is that Glass-Steagall type of regulation of a privately owned banking system was internally contradictory. It would inevitably lead to deregulation.

The process of dismantling the Chinese Walls separating different segments of the financial sector began in 1982, when the Office of the Comptroller of Currency permitted several banks to set up subsidiaries to engage in the discount brokerage business. Since then the process has continued. Bank holding companies were allowed to underwrite commercial paper, municipal revenue bonds, mortgage- and consumer loan-backed securities, and corporate bonds and equities through securities subsidiaries. It was this new framework that the Gramm-Leach-Bliley (or Financial Services Modernization) Act legalized in 1999, paving the way for financial innovation and proliferation.

It is widely accepted that it is this liberalization that encouraged banks to expand into new areas and transform the nature of their intermediation activity. While banks did provide credit and create assets that promised a stream of incomes into the future, they did not hold those assets any more. Rather they structured them into pools, "securitized" those pools, and sold these securities for a fee to institutional investors and portfolio managers. Banks transferred the risk for a fee, and those who bought into the risk looked to the returns they would earn in the long term. The net result was an era of financial innovation that created products like "collateralized debt obligations" and "credit default swaps" that were the derivatives that exploded and precipitated a financial crisis.

The transformation of the financial framework, which unfolded over the last two decades and more, had many features. To start with, banks extended their activity beyond conventional commercial banking into merchant banking and insurance, either through the route where a holding company invested in different kinds of financial firms or by transforming themselves into universal banks offering multiple services. Second, within banking, there was a gradual shift in focus from generating incomes from net interest margins to obtaining them in the form of fees and commissions charged for various financial services. Third, related to this was a change in the focus of banking activity as well. While banks did provide credit and create assets that promised a stream of incomes into the future, they did not hold those assets any more. Rather they structured them into pools, "securitized" those pools, and sold these securities for a fee to institutional investors and portfolio managers. Banks transferred the risk for a fee, and those who bought into the risk looked to the returns they would earn in the long term. This "originate and distribute" model of banking meant, in

the words of the OECD Secretariat (OECD 2000), that banks were no longer museums, which “would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return”, but parking lots which served as temporary holding spaces to bundle up assets and sell them to investors looking for long-term instruments. This meant that those who originated the credit assets tended to understate or discount the risks associated with them. Moreover, since many of the structured products created on the basis of these credit assets were complex derivatives, the risk associated with them was difficult to assess. The role of assessing risk was given to private rating agencies, which were paid to grade these instruments according to their level of risk and monitor them regularly for changes in risk profile.

Fourth, the ability of the banking system to “produce” credit assets or financial products meant that the ultimate limit to credit was the state of liquidity in the system and the willingness of those with access to that liquidity to buy these assets off the banks. Within a structure of this kind periods of easy money and low interest rates increased the pressure to create credit assets and proliferate risk. Fifth, financial liberalisation increased the number of layers in an increasingly universalised financial system, with the extent of regulation varying across the layers. Where regulation was light, as in the case of investment banks, hedge funds and private equity firms, financial companies could borrow huge amounts based on a small amount of own capital and undertake leveraged investments to create complex products that were often traded over the counter rather than through exchanges. Finally, while the many layers of the financial structure were seen as independent and were differentially regulated depending on how and from whom they obtained their capital (such as small depositors, pension funds or high net worth individuals), they were in the final analysis integrated in ways that were not always transparent. Banks that sold credit assets to investment banks and claimed to have transferred the risk, lent to or invested in these investment banks in order to earn higher returns from their less regulated activities. Investment banks that sold derivatives to hedge funds, served as prime brokers for these funds and therefore provided them credit. Credit risk transfer neither meant that the risk disappeared nor that some segments were absolved from exposure to such risk.

What this experience suggests is that once structural regulation was eased, the pursuit of profit resulted in financial innovation of a kind that led to these outcomes. And the tendency intensified when an easy money policy increased liquidity in the system.

That the complex structure which delivered extremely high profits to the financial sector was prone to failure has been clear for some time. For example, the number of bank failures in the United States increased after the 1980s. During 1955-81, failures of US banks averaged 5.3 per year, excluding banks kept from going under by official open-bank assistance. On the other hand during 1982-90 failures averaged 131.4 per year or 25 times as many as 1955-81. During the four years ending 1990 failures averaged 187.3 per year. The most spectacular set of failures, was that associated with the Savings and Loan crisis, which was precipitated by financial behaviour induced by liberalization. Finally, the collapse of Long Term Capital Management pointed to the dangers of leveraged speculation. Each time a mini-crisis occurred there were calls for a reversal of liberalization and increased regulation. But financial interests that had become extremely powerful and had come to control the US Treasury managed to stave off criticism, stall any reversal and even

ensure further liberalization. The view that had come to dominate the debate was that the financial sector had become too complex to be regulated from outside; what was needed was self-regulation.

Underlying the current crisis were two consequences of the developments outlined above. First, the “originate-and-distribute” model migrated out of the banking system to other segments of the financial sector. Second, this was facilitated by the fact that in more ways than one this resulting diversification and proliferation of Finance, was leveraged by the liberalized banking system. Because of this complex chain, institutions at every level assumed that they were not carrying risk or were insured against it. However, risk does not go away, but resides somewhere in the system. And given financial integration, each firm was exposed to many markets and most firms were exposed to each other as lenders, investors or borrowers. Any failure would have a domino effect that would damage different firms to different extents.

It was for this reason, we now know, that while the problems began with defaults on subprime loans, the crisis soon afflicted the core of the financial structure: the banking sector. As in 1933 the danger of systemic failure if banks were allowed to close left the state with no choice but to step in. However, once again, with the worst economic downturn since the Great Depression having been stalled and partially reversed, the pressure to rein in unfettered finance, which generated the crisis, has eased. Moreover, with little agreement on the nature and extent of re-regulation of finance that is required, the debate goes on but little is actually being done to reform the financial system. There are, however, radical recommendations which are being advanced, even if by a minority. One such, is the demand for a reinstatement of the regulatory structure shaped in the United States by the Glass-Steagall Act of 1933.

All is not lost as yet, however. For example, in the wake of the crisis, John McCain, the Republican senator for Arizona, and Maria Cantwell, the Democratic senator for Washington state, have introduced a bill to restore the Glass-Steagall Act, which, among other things, prevented banks from using depositor’s money for securities trading. But it is not just this political move that keeps the issue on the table. On a number of occasions Paul Volcker, former chairman of the Federal Reserve has called for a new version of Glass-Steagall and a return to “narrow banking”. And Mervyn King, the governor of the Bank of England has joined the chorus with a call for “utility banking” that restricts banks to the tasks of financial intermediation and payments facilitation, and disallows speculative investments. Volcker has also argued that there was no neutral evidence whatsoever that financial innovation improves economic growth. The image and track record of these central bankers gives the demand for a return to Glass-Steagall much credibility.

Needless to say, bankers have been quick to protest, since this would not merely restrict their freedom to do “God’s work” (as Lloyd Blankfein of Goldman Sachs put it), but also limit the profits on which their bonuses depend. But as Simon Johnson, a former chief economist at the International Monetary Fund reportedly queried: "If independent experts told Congress there was a really dangerous nuclear plant that could blow up in the next 25 years, then lawmakers wouldn't take objections from the nuclear industry very seriously. So why are we only going to Wall Street for expert advice on how to re-regulate Wall Street?" Unfortunately, as of now, financial policy is still influenced by big finance, limiting progress in a policy area that needs urgent action.

This is despite the fact that assessments of the crisis and the way forward have indeed focused on the consequences of liberalization. Consider, for example, the Turner Review. Recognizing that “the

system of securitised credit intermediation was originally proposed as a mechanism for taking risk off the balance sheets of banks, placing it with a diversified set of end investors, and thus reducing banking system risks”, it concludes that this analysis has been proved wrong. It goes on to identify the reasons why a securitised credit model may be inherently more vulnerable to financial instability shocks than a model of on-balance sheet credit intermediation. First, it argues, “in a securitised system credits become marketable instruments, tradeable in liquid markets. And ... all liquid markets are inherently susceptible to periodic swings in sentiment which produce significant divergence from rational equilibrium prices.” Second, while booms and busts in equity prices have had surprisingly small consequences for the real economy the upswing and reversal in securitised credits have had substantial effects. The world economy seems to “have greater ability to absorb without dire consequences severe cases of irrational exuberance and then depression in equity prices, than in the prices of a broad range of credit instruments, held to a significant extent on the trading books of banks, shadow banks or near banks.

This, the Review argued is because of “the characteristics of banks, their central role in the economy, and the specific risks they face. Banks are highly leveraged: they perform maturity transformation which exposes them to liquidity risks: and they are involved in a process of continual rollover of new credit supply to the real economy without which economies will contract. So irrational swings in prices of credit securities held by banks, and thus in their capital resources, are likely to be far more economically significant than irrational swings in the prices of equity investments held by end investors. It is therefore possible that the growth of the securitised credit intermediation model has increased systemic risk in ways which are not just the result of poor execution – bad remuneration policies, inadequate risk management or disclosure, failures in the credit rating process – but inherent.”

Moreover, securitization had inflated the size of the financial sector relative to the real economy, as measured by the share of financial services in GDP, for reasons that had little to do with efficient intermediations required by the real economy. Rather, “some and perhaps much of the structuring and trading activity involved in the complex version of securitised credit ... achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investors and companies and between companies and individual employees.” In the event, “ Wholesale financial services, and in particular that element devoted to securitised credit intermediation and the trading of securitised credit instruments, grew to a size unjustified by the value of its service to the real economy.”

It would be expected that an assessment of this kind would lead to a demand for reverting to structural regulation of the Glass Steagall kind that limits the activities of banks to both ensure their stability as well as limit the extent of leverage in the non-bank or shadow banking system. But this is not what Turner finally makes a case for. Rather the Review cautions against overstating this case and underlines “the potential for better regulation to ensure a more robust model of securitised credit intermediation.” Reverting to the position that many of the arguments advanced in favour of securitization were sound, the Review attributes many of the problems with the securitized credit model to poor regulation, leading, for example, to the “emergence of off-balance sheet shadow banking activities and inadequately low capital requirements against trading books.”

Thus: “The challenge is to design regulatory responses which will produce a safer version of the securitized credit model – less complex, more transparent to end investors, with less packaging and trading of securitised credit through multiple balance sheets, more true distribution to end investors and more real risk diversification.” In view of the Turner report: “The most fundamental changes required to create a sounder banking system for the future are ... those relating to capital adequacy, accounting, and liquidity policies.”

This leads to recommendations geared to strengthening capital adequacy norms such as “that required capital ratios for ... banks should be expressed entirely in terms of high quality capital – broadly speaking the current Core Tier 1 and Tier 1 definitions – and should not count dated subordinated debt as providing relevant support.” Moreover, rather than see the role of trading books and desks in proliferating risk, the Review suggest that the failure of the current regime was because it required “only very light levels of capital against trading books on the grounds that the risks are low because assets can be rapidly sold and positions rapidly unwound.” Hence, the Review proposes a radical review of trading book risk measurement and capital adequacy requirements, which would cover (i) the definition of assets appropriately booked in trading and banking books; (ii) the use of VAR and other measures of risk; and (iii) the extent to which approaches should vary by trading book activity, to reflect, for instance, different liquidity characteristics.” Finally, the Review makes a case for imposing a gross leverage ratio (Asset to Capital Multiple) as a back-stop measure to deal with situations where assets normally considered liquid and less risky turn illiquid for systemic reasons.

Overall, what the Turner Review does is not just side-step but completely dismiss the case for reverting to forms of structural regulation of the Glass-Steagall kind. The reasons are not hard to identify. In the spectrum of potential returns to banking, a completely unregulated system assures the highest profits when markets are buoyant, those with capital adequacy-based regulation come next with lower returns and the system with structural regulation offers the least.<sup>1</sup> This does create a conflict between private ownership and structurally regulated banking sector. If that conflict and its implications are not addressed the required reform of the regulatory structure may be difficult to achieve.

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<sup>1</sup> The Review recognizes that even with its limited intensification of regulation: “The future world of banking probably will and should be one of lower average return on equity but significantly lower risk to shareholders as well as to depositors.”