Viewpoint: Viral Acharya and Julian Franks
Regulation after the Crash

INTRODUCTION
Julian Franks is professor of finance and academic director at London Business School's Centre for Corporate Governance. Here he reflects on the shape of future regulation of the financial services sector. His research focuses on bankruptcy and financial distress and corporate ownership and control, a field in which he has won two international prizes. He served as a member of a UK government working party reviewing the insolvency code and advised (with LBS professor Richard A. Brealey) the Office of Constitutional Affairs on the issue of outside equity for law firms and is an advisor to the regulator, Ofcom, and BAA. His qualifications include a BA (Sheffield), an MBA (Columbia), and PhD (London).

Viral V. Acharya is professor of finance at London Business School and New York University Stern School of Business, academic director of the Coller Institute of Private Equity, and a research affiliate of the Centre for Economic Policy Research (CEPR). He joined LBS in 2001 following a PhD in finance from Stern School of Business and bachelor's in computer science and engineering from the Indian Institute of Technology, Mumbai. His research interests are in the regulation of banks and financial institutions, corporate finance, credit risk, the valuation of corporate debt, and asset pricing with a focus on the effects of liquidity risk and has won a string of awards for his academic papers. He was appointed as a Senior Houblon-Normal Research Fellow at the Bank of England in summer 2008 to conduct research on the efficiency of the interbank lending markets.

Many of the issues facing us as we work through the full impact of the credit crunch and the ensuing meltdown in the financial sector are quintessentially empirical issues. They include the extent to which opaque off-balance-sheet activities and mark-to-market accounting exacerbated the banks’ problems. These issues will require a little time to study fully.

There is, therefore, a real danger that the many temporary measures we see being taken by governments around the world will be set in concrete before the issues involved have been fully digested and their implications and lessons understood. One has to hope that wisdom will prevail and that temporary solutions will remain temporary until we are all a great deal clearer as to what has happened and how we can fix it.

Here we raise a number of points that we believe are worth considering. For example, one thing that is emerging from the current downturn is that this recession is really going to test insolvency procedures, both in the United Kingdom and across Europe. There are two elements to this, namely insolvencies for traditional companies and insolvency procedures for banks and financial institutions. We shall confine our comments to the latter.

Our view is that we could benefit greatly by extending the insolvency provisions that apply to utilities to the financial services sector. In the event of a utility company failing, a special administrator regime can be applied, taking control of the company and reorganizing it in a way that takes account of stakeholders other than creditors and shareholders. At present, our insolvency laws require administrators to focus only on the needs of these two groups. However, in the special utility regime, customers come first and the regulator has the freedom to arrange matters to prioritize continued service to customers.

We are seeing a de facto move in this direction with the nationalization of the banks. However, this is not quite the same as the “ring fencing” the utility assets. When Enron imploded, because of the special utilities regime, the assets of Wessex Water, which was wholly owned by Enron, were ring-fenced from the company’s non-regulated assets. The special administrator was able to control those assets and run them not just for the shareholders and creditors, but also to the benefit of water consumers. This created a significantly different set of circumstances to those with which a traditional insolvency practitioner deals.

This kind of regime dates back to the 19th century, where the United Kingdom passed special administration rules for railways that prevented creditors from tearing up the railway lines to recoup their losses from railways that had gone bust. The United States did not follow suit and in the end the US government had to step in and break contracts to stop creditors from ripping up the tracks. Similarly, today, with busted utility companies, creditors are unable to recoup their losses by digging up the pipes for scrap.

Policymakers should give some thought to these special insolvency regimes when contemplating the future of the banking sector. The question is: what kind of bankruptcy regime do we need, going forward, for financial services companies, and which organizations should such a regime apply to? Banks? Insurance companies? Investment Banks? All of them or just a select few?

Another aspect of regulation that will have to be thought about very carefully is regulatory arbitrage. Because deposit insurance makes the cost of deposits for banks lower, what you really want to prevent, in these circumstances, is banks using the finance raised within the regulatory regime to somehow subsidize the purchase of assets that are (or, at least should be) outside the regime.

So, how do we prevent banks from using assets which are partially or fully guaranteed and which therefore have a relatively low cost of capital, from competing unfairly in other markets? How can a regulatory regime ensure that, in the event of subsidized funds being used outside the ring fence that the conventional—i.e., the unguaranteed—cost of capital is fully recognized?

One way of solving the problem would be for central banks to charge banks a risk-based, “marked-to-market” fee for their...
government guarantees. It would ensure that banks would face the full cost of capital once they moved outside the ring fence of protected assets. If the central bank does not charge a fee, or charges too low a fee, then the regulator (and ultimately government) has to ask itself how it is preventing regulatory arbitrage.

Another crucial point, of course, concerns off-balance-sheet assets. There is no question but that off-balance-sheet assets such as CDSs and CDOs have been a very serious causal contributor to the present crisis. Regulators, for reasons we and many others do not fully understand, have allowed this to happen in an uncontrolled way, and that game is now over. Already we are seeing the implementation of central clearing houses for CDSs.

The more subtle point is that banks were able to keep certain types of assets off their balance sheets because these assets were deemed to be “nonrecourse” assets by regulators. However, in most of the asset-backed commercial paper conduits there was, in fact, explicit recourse in the form of close to 100% liquidity and credit enhancement by sponsoring banks.

Even in the case of SIVs, where such enhancement was not complete, it is clear that the sponsoring bank stood behind those assets as far as its reputation was concerned. This is why so many of the SIVs whose assets lost liquidity during the subprime crisis were taken back by banks off their balance sheets.

Thus, the so-called “credit risk transfer” innovations employed during 2003 to the second quarter of 2007 were aimed at gaming regulation and taking on excessive leverage and risk, rather than generating economic efficiency. This is a very important point for regulatory authorities to get to grips with and we suspect that, when they do, it will lead to a much tighter definition of what banks can and cannot do. Once this happens, or even looks as if it is on the cards, you will get a predictable hue and cry about “the dead hand of regulation stifling innovation in the financial sector.”

THE FUTURE OF REGULATION

There are two sensible options for the future of regulation. One is to take the existing regulatory framework and to look to improve it in a variety of ways. Or the regulatory authorities can go down a different route. They can look to ring-fence the activities of banks and move the prescribed activities into other institutions that are also regulated, but that do not carry the same systemic risk (since banks occupy such a critical place in the economy). A third option is for the regulator to try to do a mix of both options. That route, in our opinion, leads to some very serious policy traps and errors for regulators.

As things stand, most governments and bank regulators are determined to avoid a depression or a profoundly deep recession. And they want to put a regulatory regime in place that will mitigate these problems if they arise again. These are laudable aims and one does not want to underestimate the scale of the issues that governments are grappling with.

Our guess is that banking activities will end up being narrowed substantially. We cannot allow banks to take on the huge risks that they have been taking on, at the same time as having their liabilities guaranteed by government. What rationale is there, for example, for guaranteeing the deposits of an institution whose revenues largely come from making markets in derivatives? So we would expect commercial banks—the deposit-guaranteed banks—to be shorn of at least some of the ability to do investment banking. Already, we have seen the big US investment banks hurrying to shed their investment banking status because they were being massively disadvantaged by the guarantees being offered to commercial banks.

It is now beyond argument that we need effective regulation and the mechanisms and structures that enable effective regulation to take place. With hindsight we can all see that it was very unfortunate that there was not a clearing house for some of these derivative products. One thinks particularly of the Credit Default Swaps (CDSs) market and the Collateralized Loan Obligations market (CDOs).

If there had been a clearing house where all these deals were registered, it would have been much clearer, at a much earlier stage in the proceedings, just who owed what to whom, how they would settle, and what the losses on specific transactions were likely to be. It is now virtually axiomatic that where you have large markets in products, and the CDS market is absolutely enormous, being valued variously at between US$40 trillion and US$60 trillion, you really do need a clearing house. There are already a number of moves to regulate and further standardize the CDS market and that is, of course, desirable.

In the United Kingdom the major commercial banks have been heavily involved over the last 20 years or more in the leveraged buyout market (LBO). Our view here is that, though we will see a high level of defaulting in the LBO market through the current downturn, the defaults are likely to be triggered through breaches of covenants at a level well above the liquidation value of the assets. Losses, therefore, to the banks should be limited. As consumer spending tightens, we are seeing some major retailing names fold, but this has tended to be because the underlying business models were not sufficiently robust.

MARKETS’ GROWING AWARENESS

A vigilant debt market can be very useful in forcing companies to face up to their weaknesses much earlier in the cycle of decline. This does not, of course, detract from the misery of the people being made unemployed. What we are seeing though, is a growing awareness that the prices many businesses paid for acquisitions were far too high and the financial institutions that provided debt funding for those acquisitions were not careful enough. There was many a deal done from which they should have walked away. Banks were chasing market share, rather than profitability and that is costing them—and the rest of the economy—clearly now.

In principle there is no argument but that banks have to be adequately capitalized, and it is equally clear that the current crisis has shown that they were not adequately capitalized for the level of risk that they were running. The regulatory regime, especially Basel requirements, failed and failed badly.

It is now a moot point whether Basel II is salvageable. Clearly we need some sort of global agreement that everyone signs up to. It would be a nightmare having different jurisdictions setting reserve capital values. Basel II was 10 years in the making and yet it clearly did not work. On some fronts, it did better than Basel I but on others, it fared much worse. Can we reconvene and mend it? That question still remains to be worked through.

What is clearly a problem with Basel II is that it far too dependent on the banks’ own assessments of risk taking. We knew about the off-balance-sheet vehicles but we decided to leave it to the banks to decide whether these vehicles carried any risk to the bank and what risk they should be accounting for. People who defend the modeling approach say that it was not the model’s fault, but the fault of the bankers. But that is the point. Capital requirements cannot be designed solely based on statistical objectives of quantifying risks; their design must also account for bankers’ incentives to “game” the requirements.

INTERNATIONAL REGULATORY POWER

That there will have to be some international agreement at the end of all this
seems inevitable. Banking has become too globalized for purely local, national decisions. Ultimately this throws up the issue of global coordination and burden-sharing during significant crises. Currently the variability of regulation across countries is significant, yet as we have seen in the current crisis, when banks fail in one country, taxpayers in other countries can find themselves being expected to pick up the bill. The UK taxpayer was not responsible in any way for the adventures undertaken by the Icelandic banks, but we still paid the price.

The ratings agencies too, have come out of things extremely badly. Products were given a Triple A rating that were by no stretch of the imagination Triple A. The people who set up these products thought the risks were diversifiable, with low correlation between the various classes of risk. In point of fact, the risks were highly correlated. To be precise, they became highly correlated during a systemic downturn.

People just did not give sufficient weight to the idea of such systemic risk. A company providing earthquake insurance must ask itself whether, in the worst case, it can meet the losses it is insuring. It is now clear that institutions such as AIG did not bother to pose this question to themselves at all. Provided there is no earthquake, selling earthquake insurance looks like free money. But it is absolutely fatal to assume that one will never happen. Of course, if you are too big to fail, the costs are primarily borne by taxpayers. And, this is why, regulation after the crash will need to primarily focus on pricing government guarantees right and precluding large-scale regulatory arbitrage by the financial sector.

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