Lessons Learned from the Financial Crisis: Implications for the Banking System and Regulators

Georg Rich

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Introduction

- The current financial crisis and the ensuing slump in global economic activity has been the most severe since the 1930s
- If we are to learn any lessons from this crisis, we first must ask how the current turmoil differs from the financial upheavals experienced in the past
- There are both similarities and differences to previous crises

Similarities to previous crises

- Virtually all the major financial crises that have erupted since the 19th century were triggered by banks taking excessive risks in their lending business and incurring losses on their loan portfolios
- The current crisis is no exception to this pattern: The crisis originated in imprudent lending activities by US banks, notably in the subprime mortgage market

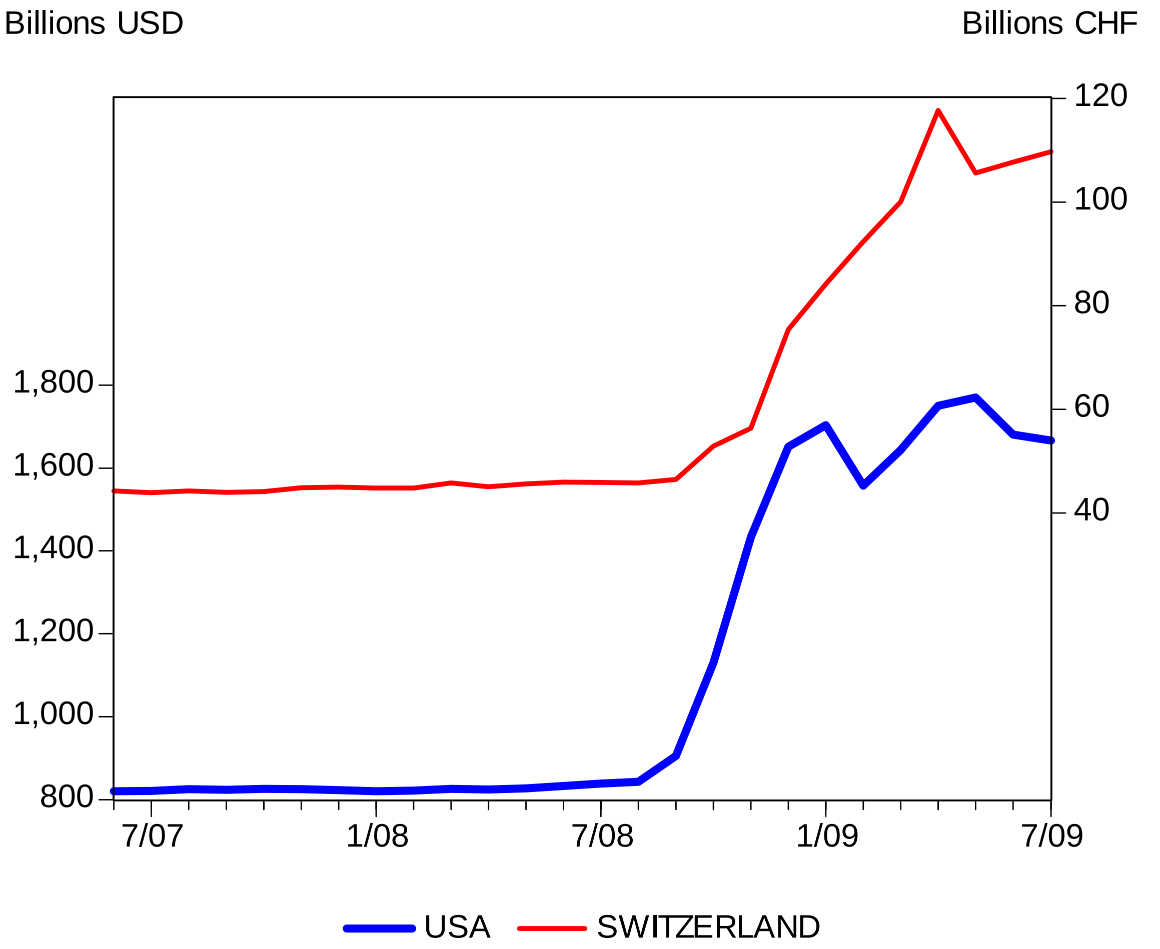
Differences to previous crises

- One notable difference rests in the collapse of the interbank lending market after the outbreak of the crisis in August 2007
- Such a collapse had not occurred since the 1930s
- It is reminiscent of similar disasters under the gold standard of the 19th and early 20th century, when the supply of liquidity to the banking system was tied mainly to the global supply of gold
- Link to gold could lead to serious shortages of liquidity in the banking system, which frequently ballooned into veritable financial crises

- Establishment of central banks almost everywhere served to sever the link between bank liquidity and gold
- Central banks can now supply whatever liquidity is necessary to maintain the smooth functioning of the banking system
- As a matter of fact, most of us had thought that major shortages of liquidity were a thing of the past
- Solvent and prudent banks could always obtain required funds on the interbank market provided the overall supply of liquidity was managed properly by the central bank

- For this reason, the inability of even solvent and prudent banks to obtain funds on the interbank market after August 2007 was puzzling indeed
- Central banks could not help acting as lenders of last resort and sole suppliers of liquidity to the banks in order avert an even greater disaster
- In my view, they took the appropriate response to the financial crisis
- As a result, the monetary base, i.e. the money created directly by the central banks, increased enormously in many countries

U.S. and Swiss Monetary Base



Collapse of the interbank market due to a large-scale breakdown of confidence in the international banking system

Several reasons

1. Excessive Leveraging

- The problems in the US subprime mortgage markets were magnified by an excessive degree of leveraging by financial institutions in the US and other industrialized countries
- These institutions created and bought mortgage-backed securities by going into debt
- Frequently, they placed theses securities in vehicles that regulators did not treat as banks but were still controlled by banks in order to bypass capital requirements imposed on banks

2. Creation of Opaque Instruments

- Mortgage- and other asset-backed securities were packed and repacked into new debt instruments and sold to banks and nonbank financial institutions, including insurance companies
- These new instruments – collaterlized debt obligations (CDOs) – lacked transparency as the owners were incapable of identifying the credit risks arising from these securities
- The owners frequently delegated this task to credit-rating agencies that were equally incapable of assessing properly the riskiness of CDOs

3. Outsourcing of Credit Risk

- Banks transferred credit risk to insurance companies and other nonbank institutional investors through credit-default swaps (CDSs)
- Assessing credit risks is one of the principal tasks of banks – If they believe they can outsource this task to nonbank investors, a fundamental question arises: Why do we need banks in the first place?
- As the current crisis clearly demonstrates, nonbank investors were incapable of replacing banks in assessing credit risk as they piled up huge losses on their CDSs and contributed importantly to magnifying the current financial crisis

4. Defects in corporate governance

- Inappropriate bonus schemes for managers and other staff in the financial sector that rewarded excessive risk taking

5. Failure of Lehman Brothers

- Before the default of Lehman Brothers, the crisis – as far as the development of real activity is concerned – seemed to be fairly normal
- The bankruptcy of Lehman Brother prompted major banks to curtail drastically their lending to risky borrowers
- This in turn elicited a serious slump in real global economic activity in the autumn and winter of 2008/09, which aggravated the bad-loan problems in the banking system

6. No banking crisis in emerging markets

- Fortunately, banks in emerging-market economies were not strongly affected by the financial crisis
- Certainly, the authorities in Asian countries learned a lesson from the crisis of 1997 and beefed up bank supervision, thus forestalling a similar disaster in 2008/09

Implications for Regulation and Supervision of banks

- The current crisis is often viewed as the disastrous consequence of unrestrained capitalism and lack of regulation
- However, the financial sector already belongs to the most regulated of the economy
- Many recent excesses in financial markets did not reflect lack of regulation but ineffective supervision by existing regulatory bodies

Examples of Ineffective Supervision

- US supervisors could have stepped in or asked the authorities for additional powers to prevent excesses in the subprime mortgage market
- The US Securities and Exchange Commission – the supervisor or the securities underwriting business – could have taken a close look at the opaque instruments floated in the capital market

- The British supervisors could have prevented the now insolvent Northern Trust from financing real-estate loans by borrowing funds on the interbank market
- German and Swiss supervisors could have challenged their banks' overexposure to mortgage-backed US and other securities
- The following table illustrates the consequences of overexposure in the Swiss case: It shows the toxic assets acquired by the Swiss National Bank (SNB), Switzerland's central bank, from the major Swiss bank UBS in order to avert a failure of that institution (toxic assets held in the SNB's StabFund as of April 2009)

Investments of StabFund (Billions USD)

Total for US	**25.5**
Residential mortgage-backed securities	9.6
Residential loans	0.6
Commercial mortgage-backed securities	4.4
Commercial real estate loans	2.4
Asset-backed securities consumer	2.0
Asset-backed securities other	1.8
Collateralized debt obligations	3.2
Corporate	0.5
Student loans (loans and ABS)	0.9
Total for Europe	**12.9**
Residential mortgage-backed securities	5.4
Residential loans	0.6
Commercial mortgage-backed securities	2.2
Commercial real estate loans	0.5
Asset-backed securities other	1.3
Collateralized debt obligations	2.9
Total for Japan	**0.3**
Commercial real estate loans	0.3
Total investments	**38.7**

Little debate about improving existing supervision

- Hard to come up with easy solutions
- Dilemma: Are supervisors better able to assess credit risks than the banks themselves?
- Customers can also contribute to improving the performance of their banks: They should refuse to buy opaque instruments whose risks they cannot properly assess
- Unfortunately, customers frequently dazzled by high returns and oblivious to risks they incur

Much of the Current Debate Revolves around the Need for Tightening up Existing Regulations and for New Regulations

- Three types of proposals
  - Reasonable
  - Reasonable if properly implemented
  - Unreasonable or even dangerous

Reasonable Proposals

- Schemes for raising or redesigning capital requirements imposed on banks on order to reduce the likelihood of bank insolvencies:
  - However, it is impossible to regulate away entirely risks of insolvencies unless banks are compelled to hold capital equaling 100 percent of their assets, which would turn them into mutual funds
  - Procyclical variations in capital requirements
  - Progressive capital requirements to discourage the development of big banks

- This would contribute to mitigating the "too big to fail" problem as big banks would be required to hold more capital in relation to their assets than small institutions
- Failures of very large banks may prompt a collapse of the entire financial system
- Therefore, governments generally have no choice but to rescue such institutions
- Moral risk: If institutions know that in case of trouble they will be rescued by the government, they may take excessive risks and pave the way for the next financial crisis

- Liquidity requirements?

Maybe Reasonable

- Regulate bonus schemes:
  - Popular view in Europe in particular: The financial crisis was caused mainly by greedy bankers seduced by inappropriate bonus schemes into taking excessive risks
  - Bonus schemes did play a role but were not the main cause of the crisis: German savings banks also purchased toxic assets although they did not pay out excessive bonuses
  - In redesigning bonus schemes, we should avoid populist overkill

- Mark-to-market accounting rules:
  - One may question the wisdom of mark-to-market valuation of the banks’ assets and liabilities
  - Nonetheless, any modification of accounting rules should ensure that the transparency of the banks’ financial statements does not get lost as the methods for valuing assets and liabilities are changed

- Radical measures to deal with “too big to fail”:
  - Convey to the authorities the right to break up, downsize and restructure banks deemed to be too big
  - I am skeptical about such proposals as they would imply de facto nationalization of big banks, with the authorities becoming fully responsible for any mistakes committed by such institutions
  - Is this really the banking world we wish to create?

Unreasonable or dangerous

- Regulate hedge funds and private equity companies:
  - Some large hedge funds may pose systemic risks
  - However, these institutions were not responsible for the outbreak of the crisis

- Regulate rating agencies:
  - Constitutes little more than a fig leave concealing a fundamental problem: Who is to assess credit risks?
  - As indicated earlier, this is the classic task of banks – It is not obvious why rating agencies or the regulators of rating agencies should do a better job in assessing credit risks than the banks
  - If the responsibility for properly assessing credit risks ultimately rests with the regulators of the rating agencies, we will see the creation of a regulator of the regulators of the rating agencies after the eruption of the next financial crisis

- A better solution would be to require banks to retain a portion of credit risks on their books provided they try to transfer that risk to other institutions through securitization of loans or through issues of CDSs

- Government interference in bank lending:
  - Equally unreasonable is the tendency of certain European governments of using the current crisis as a pretext for interfering directly in the lending business of banks
  - While banks clearly made mistakes, this does not imply that politicians and bureaucrats are equipped with the knowhow and wisdom required to allocate properly the scarce funds available for lending

Despite current zeal for tighter regulation, we should not forget important facts

- It is the task of banks and other financial institutions to take risks
- Institutions taking risks may reap huge profits but they also face the prospect of incurring huge losses
- If huge losses should arise, we cannot rule out the possibility of financial crises breaking out
- All we can hope for is that with sensible regulations and effective supervisors the economic damage caused by financial crises remains limited

- As I indicated earlier, the banks’ customers can also contribute to averting crises by refusing to be lured into unwise investment decisions by the promise of high returns and by staying away from financial products they do not fully understand

Consequences for Vietnam

- Vietnam and other East Asian countries were strongly affected by the slump in global activity through a drop in exports and outflows of capital as foreign investors sought refuge in low-risk assets
- Nevertheless, though non-performing loans increased, there was no banking crisis
- East Asian countries seemed to have learned a lesson from the crisis of 1997 as banks generally behaved responsibly and supervisors did a good job

Emphasis on Bank Capital

- If we can learn any lessons from the current crisis, it is that banks should be required to hold more capital than in the past
- Therefore, Vietnamese authorities should continue with their efforts ensuring that banks hold sufficient capital
- They might also consider the possibility of varying capital requirements procyclically
- There are signs that the East Asian economies are recovering again

- As the Vietnamese economy moves out of the current recession, the authorities will have to tighten monetary and fiscal policies in order to forestall a resurgence of inflation
- Raising capital requirements during the cyclical upswing could contribute to preventing a credit-led bubble with inflationary consequences
- Otherwise, Vietnamese authorities should not pay too much attention to pronouncements of the G-20 and similar bodies
- Much of that rhetoric is a smoke-screen designed to conceal mistakes of supervisors in the industrialized countries

- Instead, Vietnamese authorities should continue with reforms aimed at strengthening the health of the financial sector
- If I understand the situation correctly, there are several issues the authorities need to resolve

Issues to be resolved

- Supervision of state-owned commercial banks (SOCBs): Can the State Bank of Vietnam (SBV) be an effective supervisor if it or other public bodies are simultaneously owners of the SOBCs?
- Joint-stock banks: Are they effectively supervised by the SBV? Since they are partly controlled by non-financial state-owned companies (SOEs), is there a danger that they will lend to SOEs, rather than to private firms? How can the flow of bank credit to private companies be strengthened?

- Supervision of equity markets: The development of these markets is hampered by a lack of transparency on the part of listed companies – How can disclosure and corporate governance of listed companies be improved?
- The Vietnamese bond market is still small compared to those in other East Asian countries: What can be done to improve the functioning of the bond market?