

Lessons from the Global Financial Crises

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- ◆ What Caused the Global Financial Crisis of 2007-2009?
- ◆ What Caused the European Sovereign Debt Crisis?
- ◆ What Lessons Can We Learn?
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Introduction

- ◆ Basel III and the “Volcker Rule” are all responses to the Global Financial Crisis of 2007-2009.
- ◆ In order to design and formulate policies to prevent the recurrence of a similar crisis, it is necessary to understand the causes of the crisis itself.

What Caused the Global Financial Crisis of 2007-2009?

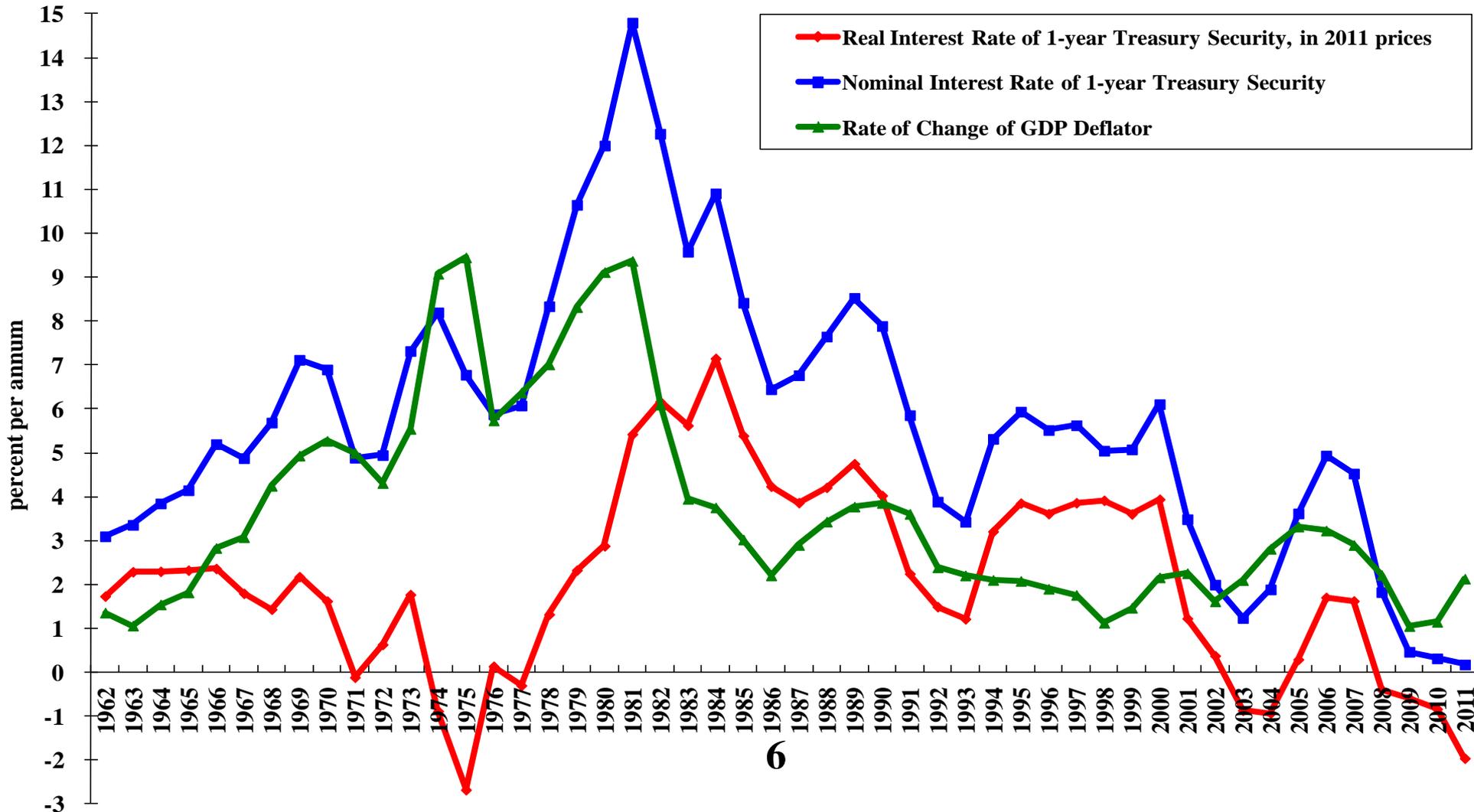
- ◆ The causes of the Global Financial Crisis of 2007-2009 can be classified into four categories:
- ◆ (1) Easy money in the United States;
- ◆ (2) Irrational exuberance unrestrained;
- ◆ (3) Failures of regulation and supervision; and
- ◆ (4) Defects in the institutional design.

What Caused the Global Financial Crisis of 2007-2009? Easy Money

- ◆ The real rate of interest in the U.S. has been kept low and often negative since 2001 (see the following charts). Low and often negative real rates of interest encouraged borrowing and the use of leverage and fed the bubble in asset prices, especially real estate prices, in the U.S. and elsewhere. The high rate of growth of money supply relative to the rate of growth of GDP coupled with the low rate of inflation of the prices of goods in the U.S. meant that the excess money balances would go into the asset (real estate and securities) markets, driving up the asset prices.
- ◆ The market risk premium before the outbreak of the global financial crisis was at an all time low as indicated by the very thin interest rate spread—less than 100 basis points--between junk bonds and U.S. Treasury securities of similar maturity in early 2007. This should not have been possible as no matter how clever a financial engineer may be--someone must ultimately wind up with the bad risks.

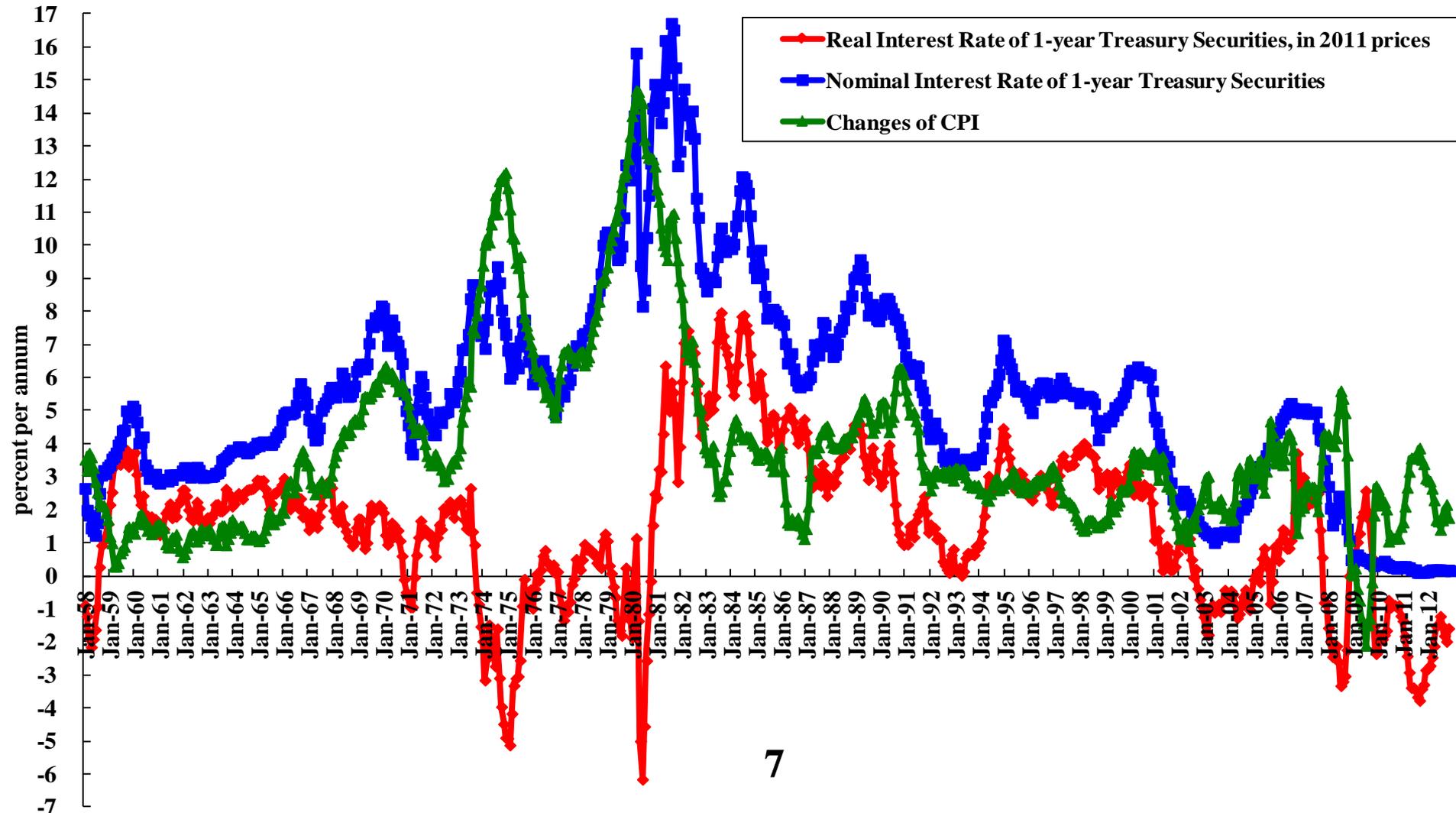
Nominal and Real Interest Rates of 1-year U.S. Treasury Note and U.S. GDP Deflator

Nominal and Real Interest Rates of 1-year U. S. Treasury Note and the Rate of Inflation



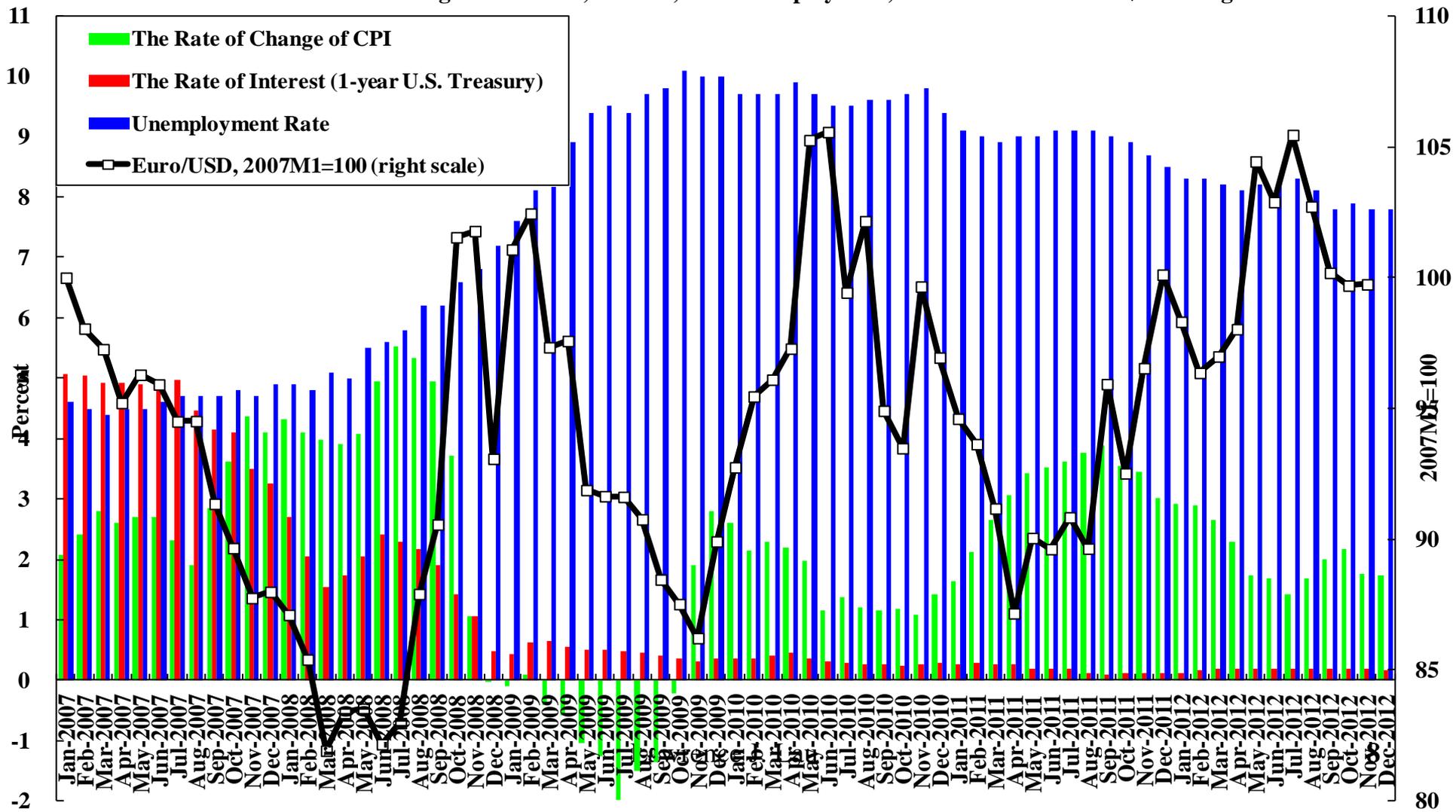
Nominal and Real Interest Rates of 1-year U.S. Treasury Note and U.S. CPI Index

Nominal and Real Rate of Interest of 1-year U.S. Treasury Securities and the Rate of Inflation



The Rates of Change of CPI, Interest, & Unemployment, & Index of Euro/US\$ Exchange Rate

The Rates of Change of U.S. CPI, Interest, and Unemployment, and Index of Euro/US\$ Exchange Rate



What Caused the Global Financial Crisis of 2007-2009? Irrational Exuberance

- ◆ Irrational exuberance is not uncommon--economic and financial bubbles have occurred from time to time all over the World for centuries, driven by (initially) self-fulfilling asset price expectations and abetted by the heavy use of leverage.
- ◆ However, bubbles can and should be contained and restrained by the suitable and timely restrictions on the use of leverage. For examples, the loan-to-value ratio of home mortgages can be lowered; the margin requirements for the purchase of common stocks can be raised. Other instruments include increasing the stamp duty/transaction taxes, and increasing the capital gains tax rate on assets (property and securities), especially on assets held only for a short duration. There are many other different ways of lowering the expected net after-tax return of speculative investments and thus discouraging them.

What Caused the Global Financial Crisis of 2007-2009? Irrational Exuberance

- ◆ If bubbles are left entirely to the market, they will certainly eventually burst anyway but then they will have become much bigger and will therefore do much greater damage to the economy. Pricking a bubble early actually protects the investors who are the least knowledgeable and are often the last to enter the market and hence are “left holding the bag,” as well as the economy from the spillover effects.
- ◆ Recovery of an economy from a burst asset price bubble can take years or even decades. For example, the Japanese economy has yet to recover fully from the bursting of its property price bubble in 1990.
- ◆ Unfortunately, the governmental authorities were unwilling and unable to restrain the irrational exuberance.

What Caused the Global Financial Crisis of 2007-2009? Regulatory Failures

- ◆ Why were the serious regulatory failures that allowed the global financial crisis to occur possible?
- ◆ The first fundamental reason is the overly strong faith on the part of the financial regulators that whatever could go wrong “the market would take care of it.” It turned out that the market, in the absence of proper regulatory oversight, could not take care of it in a timely manner, before huge damage was done.
- ◆ The second fundamental reason is a phenomenon known as regulatory capture—over time the regulatory agencies have been “captured” by those same firms they are supposed to regulate, through lobbying and other efforts by the latter, and are thus frequently persuaded to relax regulatory requirements in favour of these firms.

Areas of Regulatory Failures

- ◆ Regulatory failures have been manifested in many areas. The principal areas of regulatory failures, in addition to the failure to restrain irrational exuberance, are:
- ◆ (1) Excessive leverage of financial institutions (as well as some non-financial firms) and of the financial sector as a whole;
- ◆ (2) Failure to ensure competitive markets; and
- ◆ (3) Failure to control moral hazard.

Excessive Leverage

- ◆ Excessive leverage of a firm implies that it is more likely to fail because an ever so slightly temporary setback can turn the net worth of the firm negative and hence put the firm into bankruptcy.
- ◆ Moreover, excessive leverage encourages moral hazard (recklessness) on the part of the borrowing firm because the managers/owners/shareholders lose relatively little, with the bulk of the losses borne by the creditors, when the firm fails, but retain the bulk of the profits when the firm succeeds.
- ◆ Excessive leverage of a firm also in turn increases the risk of other firms doing business with it or having such a firm as a “counterparty.”
- ◆ Excessive leverage of a firm also magnifies the negative spillover effects of its potential bankruptcy—not only does it have to shut down but its failure also impacts negatively all of its creditors, contractors, lenders and suppliers, firms that may otherwise be well managed but happen to do business with it.

Excessive Leverage

- ◆ Furthermore, at a macroeconomic level, excessive leverage, if widespread, enables and magnifies the domino effect of the insolvency and bankruptcy of a firm on the entire financial system through the resulting failures of the firm's creditors (including banks), contractors, lenders and suppliers, which may in turn trigger additional failures if they are also excessively leveraged.
- ◆ Excessive leverage also enables speculators (e.g. hedge funds) to take sufficiently dominant long or short positions in the markets of certain financial instruments (for example, credit default swaps (CDSs)) to affect the market outcomes and to engage in predatory speculation on a large scale.

Excessive Leverage

- ◆ Because of the potentially large negative externalities that excessively leveraged financial institutions can create, there should be strict limits on the degree of leverage they can use. This is what Basel II and Basel III are about—more capital means less leverage, other things being equal.
- ◆ The U.S. regulators (Securities and Exchange Commission) made the mistake of relaxing the capital requirement on the U.S. securities firms some time in the early 2000s, which in turn allowed these firms to achieve their high leverage, at the request of a group of large U.S. securities firms.
- ◆ In addition, many financial institutions undertook off-balance-sheet activities (for examples, “special-purpose vehicles (SPVs),” “special investment vehicles (SIVs),” “structured investment vehicles (also known as SIVs),” “shadow banking” and the like) to hide their true degree of “excessive leverage.”

Excessive Leverage

- ◆ When should leverage be considered to be excessive?
- ◆ Leverage is considered to be excessive when the assets-to-equity ratio is greater than 12.5 to 1 for a financial institution (following the currently accepted international practice of 8% capital requirement) and greater than 5 to 1 for a non-financial firm (the norm for New York Stock Exchange-listed non-financial firms is no more than 2 to 1).

Excessive Leverage

- ◆ Long Term Capital Management (LTCM), a hedge fund, failed in 1998 in part because of its high leverage—at the time it had capital of approximately US\$4 billion but assets of approximately US\$100 billion and even greater potential liabilities.
- ◆ Bear-Stearns and Lehman Brothers had leverages of between 30 and 50 to 1 when they failed.
- ◆ UBS reportedly had a total assets to net worth (stockholders' equity) ratio of 64 and Deutsche Bank and Barclays had a ratio of 53 at the end of 2007.
- ◆ In financial crisis after financial crisis, it has always been the excessive leverage that causes the negative domino effect on the rest of the economy. When a badly managed but highly leveraged firm collapses, it brings down with it all of its creditors, contractors, lenders, suppliers, and counter-parties in its financial derivative transactions, in addition to its own shareholders. It also causes all of its employees to lose their jobs.

Excessive Leverage

- ◆ The excessive leverage of banks in developed economies did not just happen overnight. It was the combined result of lax regulation and supervision, “regulatory capture,” and the competitive pressure in the financial markets.
- ◆ Banks compete with one another. If a bank is allowed to have a higher leverage, its return on equity will be higher than its competitors, at least in the short run. In order to compete effectively, its competitor banks will need to emulate the high leverage, resulting in excessive leverage across the board.

Failure to Ensure Competitive Markets

- ◆ Markets yield economically efficient outcomes only if they are competitive.
- ◆ Markets are competitive only if they fulfill the following basic conditions:

Failure to Ensure Competitive Markets

- ◆ (1) All market participants and potential market participants have access to the same or nearly the same information (although their expectations of the future may be different);
- ◆ (2) All market participants and potential market participants are small relative to the market so that no one participant can affect the outcome of the market significantly through its actions or inactions;
- ◆ (3) All market participants and potential market participants are free to enter or exit the market at any time; and
- ◆ (4) There is no explicit or implicit collusion among the market participants.

Failure to Reduce Information Asymmetry

- ◆ Financial markets can be efficient only if there is no important information asymmetry, that is, only if all market participants have access to the same information. When not all market participants have the same information, the market system is no longer efficient or fair (the playing field is not level). Hence, full and complete disclosure of financial information by publicly listed companies must be required.
- ◆ In addition, the markets can be efficient only if investors with large positions do not abuse their monopolistic or monopsonistic powers. All large investors should be required to disclose their positions on securities and other traded instruments held if they exceed a certain threshold and their transactions, including off-exchange transactions (this rule is already in force on many public exchanges).

Failure to Reduce Information Asymmetry

- ◆ Accurate and timely information on publicly listed companies is also necessary in order to enable their good governance.
- ◆ Regulatory agencies have a responsibility of assuring symmetry of information and full disclosure in order to ensure the competitiveness and fairness of the public markets.

Failure to Reduce Information Asymmetry

- ◆ The regulatory agencies failed to demand full and complete disclosure of financial information and large financial transactions, especially transactions conducted off public exchanges, by large financial institutions and other publicly listed companies.
- ◆ For example, when the same financial derivative instrument is sold to different market participants at different prices at the same time (which can happen since the transactions are not executed on a public exchange), the market will fail to be efficient or fair.

Failure to Reduce Information Asymmetry

- ◆ In most public markets, disclosure of significant ownership interest is required of a single investor or a group of investors acting in concert (e.g., over 5 percent ownership of a publicly listed company).
- ◆ When one market player has a large enough market position to influence or manipulate the market outcome, but fails to disclose it, the market outcome is neither efficient nor fair and the interests of small investors are not adequately protected.
- ◆ This disclosure requirement, however, has not been extended to markets for certain forward and futures contracts and financial derivatives, resulting in severe information asymmetry. It should be extended.

Failure to Reduce Information Asymmetry

- ◆ There may also be serious conflicts of interest if a market participant is simultaneously acting as a principal for its own account and as an agent for others, for example, when a financial institution promotes a security but at the same time sells it from its own proprietary portfolio without disclosing it. Such potential conflicts should always be required to be disclosed prior to the transaction(s).

Failure to Reduce Information Asymmetry

- ◆ One area that deserves some thought is the disclosure of exposure to counter-parties with whom the firm has transactions. There is a limit to how much a well-managed bank can lend to a single customer at any one time as a percentage of the bank's net worth, a cap on the degree of exposure to the customer. However, no similar limit exists on its exposure to a single counter-party. The bank should know its counter-party's total outstanding potential liabilities relative to the counter-party's net worth. There should be an explicit limit on the degree of exposure to individual counter-parties based on information on their credit-worthiness and aggregate exposure, beyond simple reliance on their credit ratings.

Failure to Ensure Competitive Markets

- ◆ Moreover, there should also be some rules as to the maximum share of a given financial instrument that an investor is permitted to hold at any given time in certain markets, like the rule that no firm is permitted to bid for more than 25 percent of a given U.S. Treasury issue. For example, in the oil futures market for delivery or settlement as of a certain date, no one investor or group of investors acting in concert, should be allowed to own beyond a certain percentage of the total.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ Information asymmetry is also created when the financial balance sheet of a corporation fails to provide a true picture of the corporation's conditions, for example, when the corporation has significant off-balance-sheet activities.
- ◆ Off-balance-sheet activities conducted by Enron Corporation were the principal cause of its collapse. Enron ultimately had to recognise on its balance sheet all the losses incurred in its off-balance-sheet activities. The venerable auditing firm Arthur Andersen was also dragged down along with Enron. It was the largest corporate bankruptcy in the United States before the failure of Lehman Brothers.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ By allowing off-balance-sheet activities, corporations are implicitly encouraged to take “hidden actions,” and that further increases moral hazard. Such hidden actions enable the firm to take on excessive leverage and circumvent regulations on capital adequacy without the knowledge of its board of directors, its shareholders, the public and even the regulatory agencies.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ However, neither the U.S. Securities and Exchange Commission nor the U.S. Congress learnt the lessons of the failure of Enron Corporation and have continued to allow publicly listed companies to engage in off-balance-sheet activities. The Sarbanes-Oxley Act of the United States, which is supposed to prevent a recurrence of failures such as Enron, fails to address this most important issue at all, despite its many costly and intrusive provisions on corporate governance and auditing.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ Many of the world's largest banks, Citicorp, HSBC, UBS, etc. suffered huge losses in this financial crisis because of their off-balance-sheet activities in the form of “special investment vehicles (SIVs)” or “structured investment vehicles (also known as SIVs),” and ultimately had to take these off-balance-sheet activities onto their balance sheets and write off hundreds of billions (US\$) of bad assets.
- ◆ This is one of the principal reasons for the high actual as opposed to the disclosed leverage of many financial institutions in the 2007-2009 crisis.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ Even sovereign governments such as Greece engaged in off-balance-sheet activities with the help of some financial institutions. Had off-balance-sheet activities been outlawed, Greece might still be in trouble, but the problems would have come to the surface earlier and it would not have been in such bad shape.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ The regulators did not learn their lessons and allowed the same mistakes to be repeated in an even bigger way.
- ◆ If publicly listed companies were forbidden to engage in off-balance-sheet activities, all of these losses could have been avoided, and the securitised sub-prime mortgage loans would not have found such a ready group of purchasers.
- ◆ Moreover, a great deal of the shadow banking activities, e.g., those involving the so-called auction-rate securities, had the implicit and explicit support of the major banks but were not regulated nor reflected as potential or contingent liabilities of the banks.

Information Asymmetry and Off-Balance-Sheet Activities

- ◆ One should also include in off-balance-sheet “shadow banking” activities the offering for sale participatory interests in the loans camouflaged as investment products at the retail level with implicit or explicit guarantees by the bank. Any implicit or hidden liability that is not properly disclosed in the balance sheet should be prohibited.

Information Asymmetry and Credit Ratings

- ◆ The credit ratings provided by the credit rating agencies have lost much of their credibility and reliability, further aggravating the problem of information asymmetry. There are good reasons why credit ratings are not as reliable as they used to be. They will be discussed below.

Failure to Control Moral Hazard

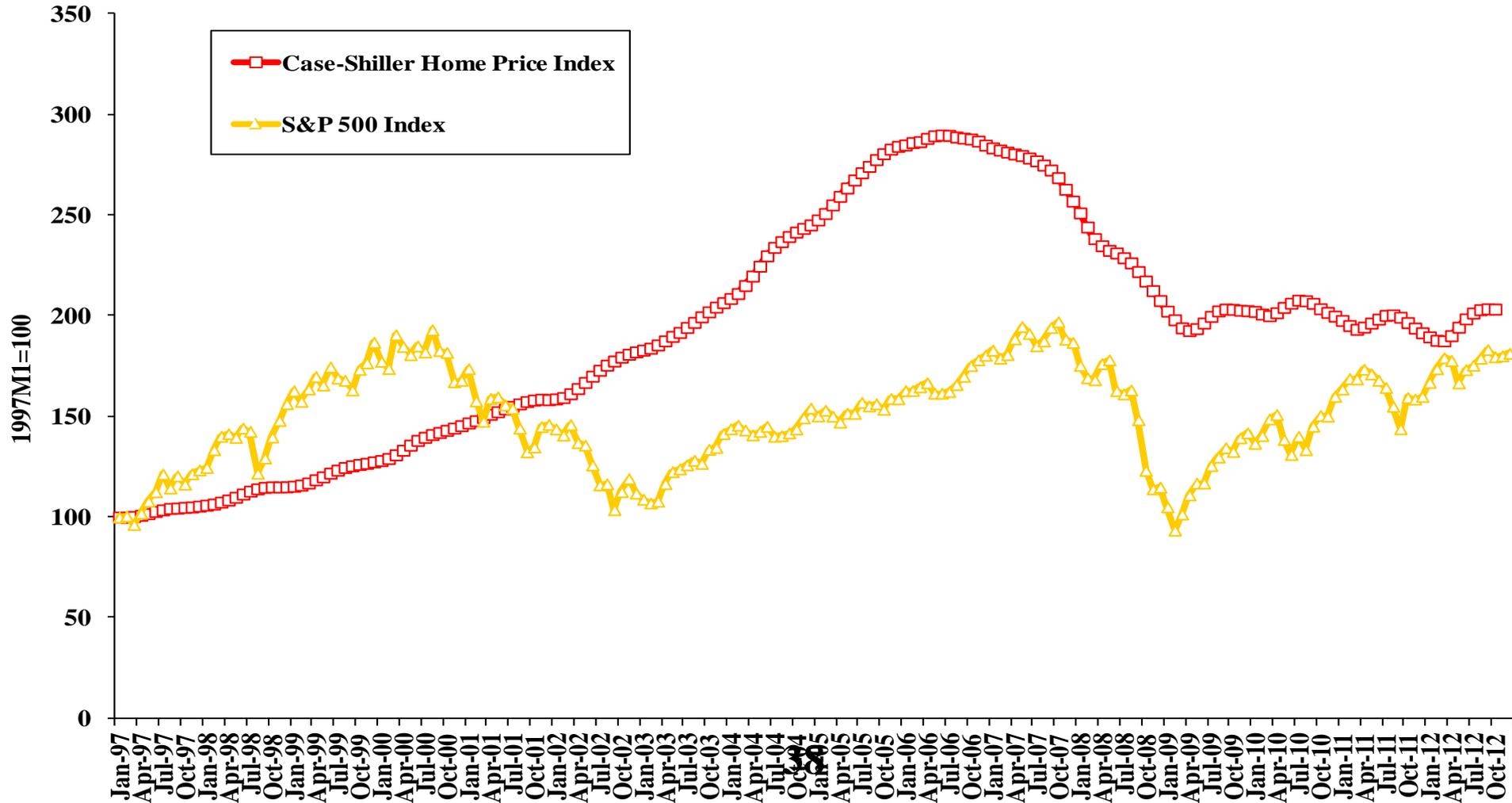
- ◆ It is well known that moral hazard on the part of the various market participants, if not appropriately recognised, discouraged and restrained, can play havoc with the markets and institutions and increase the overall risk to the financial sector and the entire economy. The regulators should develop rules and regulations and promote practices that discourage moral hazard on the part of the different market participants in the financial sector.
- ◆ However, the regulators failed to do so—there was moral hazard everywhere, ranging from the originating mortgage lenders, credit rating agencies, purchasers of credit default swaps, asymmetric incentive compensation of executives of firms, especially financial institutions and hedge funds, and being “too big to fail,” to name only a few. Each of these moral hazards will be discussed in turn.

Moral Hazard and the Originating Mortgage Lenders

- ◆ The sub-prime mortgage loan crisis in the U.S., which was the beginning phase of the 2007-2009 global financial crisis, was possible in large part because of the failure of the regulators to control the moral hazard of the originating mortgage lenders.
- ◆ The originating lenders of sub-prime mortgage loans made residential mortgage loans to borrowers with no capacity for repayment of either interest or principal, based only on a vague hope of a possible appreciation of the price of the property in the future.
- ◆ In the following chart, the Case-Shiller U.S. Home Price Index, which can be taken as a proxy for the asset price inflation in the U.S. residential housing market, is presented. The chart shows clearly that the U.S. Home Price Index began to rise in 1997 and managed to almost triple by 2006 when it reached its peak and began its decline. The Index has begun to stabilise somewhat recently, in part because of improved credit conditions for the housing market. But it is not expected to rise again any time soon.

Case-Shiller U.S. Home Price Index and the S&P 500 Index, 1997M1=100

Comparison of Case-Shiller U.S. Home Price Index and S&P 500 Index (1997M1=100)

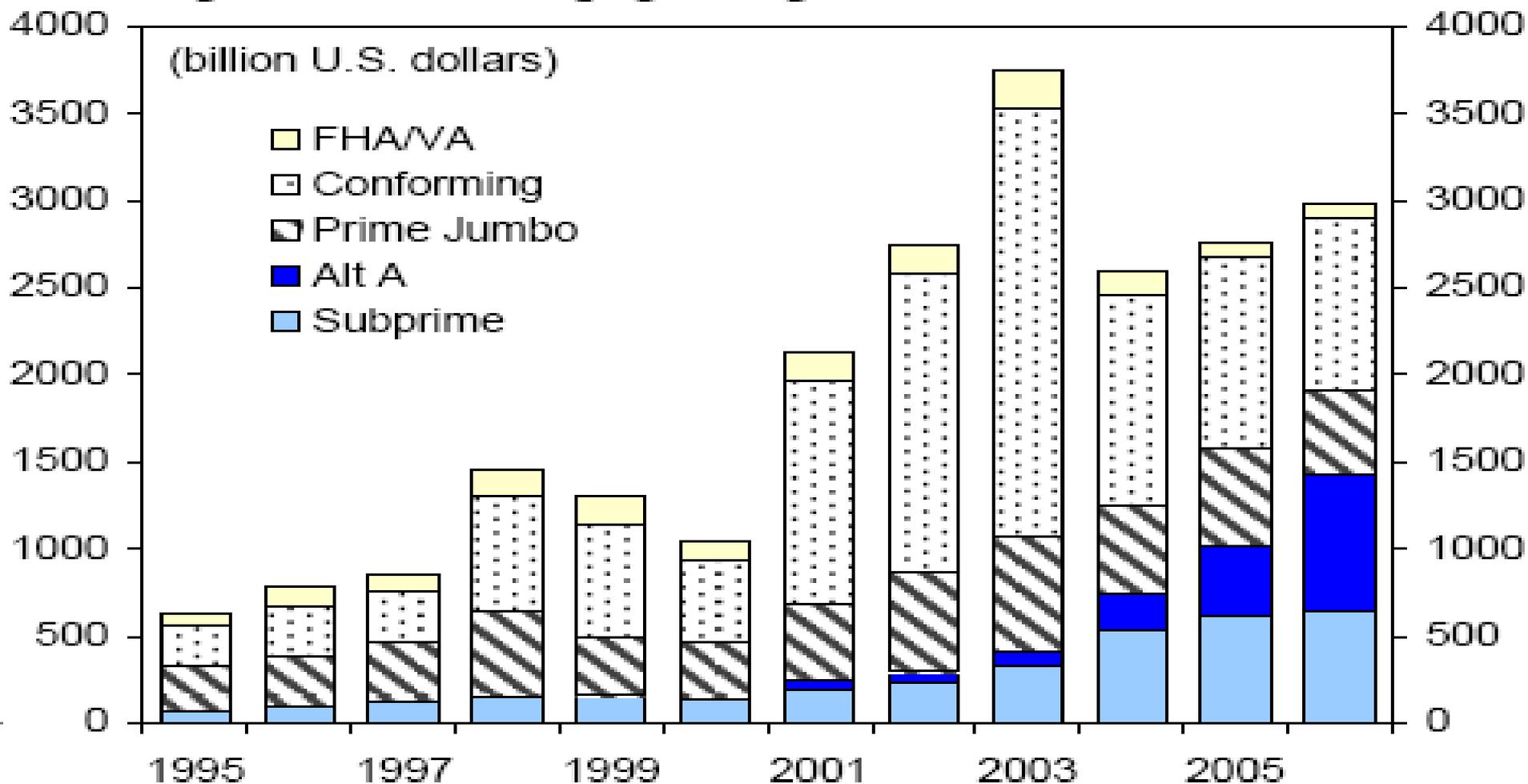


Moral Hazard and the Originating Mortgage Lenders

- ◆ The originating lenders were allowed to sell these mortgage loans off through securitisation with no residual liability. Thus, they had no incentive to make sure that the loan would perform—that the borrower was credit-worthy and had a means of repayment and that the collateral was worth its value. There was no attempt to check the borrower’s credit-worthiness or the property’s real value, since the mortgage loans would be sold to other investors without recourse to the originating lender.
- ◆ The volume of substandard mortgage loans (including both Alt-A and sub-prime loans) began growing in 2000 and by 2006 accounted for almost half of all mortgage loans made in the United States (see the next slide).
- ◆ It was these sub-prime mortgage loans that drove up the home prices successively in all segments of the market.

Growth in U.S. Mortgage Originations: from John Kiff and Paul Mills (2007)

Figure 3. All Mortgage Originations



Source: Inside Mortgage Finance.

Moral Hazard and the Originating Mortgage Lenders

- ◆ If the originating mortgage lending institution were required to retain some residual liability, e.g., a mandatory buy-back if the loan does not perform during the first three years of the life of the loan, or a holdback of 10 percent of the value of the mortgage loan for three years, contingent on loan performance, or a requirement to hold say 5 percent of the mortgage loan itself for the life of the loan, subordinated to the buyers/owners of the rest of the mortgage loan, it would have been much more careful and discriminating in making the loans and the sub-prime mortgage loan crisis could have been largely avoided. Provisions such as these have been introduced in the recently proposed reform of financial regulation in the United States.

Moral Hazard and the Originating Mortgage Lenders

- ◆ Securitisation without any residual liability encourages moral hazard on the part of the originating mortgage lenders. Ultimately the purchasers of these sub-prime mortgage loan-backed securities could only rely on the ratings given by the credit rating agencies on these securities. But the credit rating agencies also had no liability for mis-rating, but were compensated for providing ratings satisfactory to the issuers of these securities, creating yet another potential moral hazard.

Moral Hazard and Credit Ratings

- ◆ It does not help that the credit rating agencies did not fulfill their function of properly assessing the risk of the sub-prime mortgage loan-backed securities, or for that matter, other similar asset-backed securities.
- ◆ One of the problems is that a credit rating agency is nowadays paid by the firm it rates, but if the firm does not like the rating it receives from that particular credit rating agency, it does not have to pay but can go on to another credit agency until it finds one that will give it a satisfactory rating. But credit rating agencies want and need to be paid, and may therefore compromise their judgment (thus moral hazard once again). Thus, published credit ratings are likely to be biased upward.
- ◆ These credit ratings can therefore sometimes be worse than worthless. The information embodied in the credit rating is unreliable and misleading and give investors and potential investors a false sense of security.

Moral Hazard and Credit Ratings

- ◆ In any case, credit rating agencies are probably not very useful ex ante; because if they are really good at discriminating between the good and the bad securities as to their true relative riskiness, they should be in the asset management business, investing real money for clients and making a great deal more money for themselves in the process, and not in the credit rating business.
- ◆ Credit ratings of firms and securities are most often down-graded only after the whole World knows of their problems.
- ◆ The credibility of credit rating agencies is not helped by their not being able to “put their money where their mouths are.”
- ◆ Credit ratings are most typically used by asset managers to defend themselves when things turn sour—”The securities were rated AAA. What could I have done?”

Moral Hazard and Credit Ratings

- ◆ In as early as 2007 the interest rate spread between junk bonds (and sub-prime mortgage loan backed securities) and U.S. Treasury was less than 100 basis points. This should not have been possible because no matter how clever one might be in financial engineering, someone has to wind up assuming the bad risks. The credit rating agencies might have contributed to this super-thin risk premium on junk bonds with their in-retrospect overly optimistic credit ratings.

Moral Hazard and Credit Ratings

- ◆ The credit rating agencies need to be regulated, or better yet, reformed. In particular, the moral hazard can be greatly reduced if the firms being rated are not permitted to “shop” the rating, that is to have a choice whether to pay the firm doing the rating depending on the result.
- ◆ One may need to develop a penalty regime for credit rating agencies so that they will have to pay for their over-rating mistakes (just like the auditors for their auditing mistakes).

Moral Hazard and Credit Ratings

- ◆ However, since credit rating agencies never have to put their money where their mouth is (they do not suffer any financial loss if their ratings prove wrong), so it is difficult to design an incentive system for them to improve the accuracy and hence usefulness of their ratings.
- ◆ Ultimately, it may be more useful to require the underwriters of a bond issue to retain 5 or 10 percent of the entire bond issue in their own portfolio for the duration of the maturity of the bonds. This way, they will have an incentive to do proper due diligence and they will no longer be underwriting “junk”. This should give potential investors in the bonds much more confidence than an AAA credit rating. However, this also means that the underwriters will need much more capital than before.

Moral Hazard and Third-Party Investment Products

- ◆ In some economies, commercial banks are allowed to sell third-party investment products at the retail level, without no explicit residual liability. This also creates moral hazard.
- ◆ In general, investment products, which are not insured (as bank deposits are), should not be sold by the commercial banks at the retail level. For example, the Lehman minibonds were not allowed to be sold in the U.S.

Excessive Leverage Encourages Moral Hazard

- ◆ Excessive leverage encourages moral hazard and high-risk-taking because it reduces the potential pain that may result from a loss. If a firm with net equity funds of \$1 million operates with a debt-to-equity ratio of 50 to 1, a 10% return on assets (after interest payments) translates into a profit of \$5 million and a 500% return on equity; but a -10% return, which means a loss of \$5 million, will only result in a loss of \$1 million to the shareholders of the firm (the firm will of course have negative net worth and be in bankruptcy). Thus, controlling excessive leverage also reduces moral hazard.
- ◆ However, moral hazard, that is, “hidden action,” and lack of full information disclosure, also help to enable excessive leverage. For example, keeping potential liabilities off the balance sheet of a financial institution enables that institution to have a much higher actual leverage than otherwise allowed by the regulatory agencies.

Moral Hazard and Credit Default Swaps

- ◆ It is well known that insurance is subject to moral hazard, that is, the insured may for other reasons undertake “hidden action” to trigger the insurance pay-off. For example, a person may set fire to his or her own house, or to someone else’s house on which he or she has taken out fire insurance, to collect the insurance proceeds.
- ◆ Excessive insurance or over-insurance, that is, insuring a property for more than its true market value, is an open invitation to the insured to trigger the insurance pay-off, as the insured can benefit more from the insurance pay-off than from maintaining the status quo.

Moral Hazard and Credit Default Swaps

- ◆ The insurance companies have learned from bitter past experience that this may happen, and generally will insure only those who have an insurable interest, for example, they will only sell insurance to the actual owner of a house, or to the bank with the mortgage loan, but not to others, and often to offer only less-than-full market-value insurance (the insurance payoff is always with reference to the current market value). Less than full market-value insurance amounts to a form of co-payment and can discourage moral hazard. For example, if the insured of a house can only recover from insurance proceeds 90 percent of the full market value, he or she will have no incentive to burn down his or her own house to collect the insurance, and will in addition exercise due care for the house to prevent the occurrence of a fire.

Moral Hazard and Credit Default Swaps

- ◆ Credit default swaps (CDSs) are new financial instruments introduced in the late 1990s that are totally unregulated. In principle, they are insurance contracts on the bonds, the outstanding obligations, of a firm. The CDSs pay off in the event there is a default on the bonds by the issuing firm.
- ◆ As indicated above, a fundamental principle of insurance is that the insured must have an insurable interest. Otherwise it would encourage moral hazard. (And moreover, to discourage moral hazard, insurance should be less than full.)

Moral Hazard and Credit Default Swaps

- ◆ Thus, for example, it is reasonable for someone who owns Lehman Brothers bonds, or who is a contractor or supplier owed money by Lehman Brothers, to purchase a CDS from American International Group (AIG, an insurance company) up to the amount outstanding. But it is not reasonable for anyone else with no direct exposure to Lehman Brothers, especially if this person has the power to influence whether Lehman Brothers would go into bankruptcy, to purchase CDSs on Lehman Brothers, or to purchase an amount of CDS greater than the actual financial exposure.
- ◆ However, the insurance companies that sold CDSs lost sight of the fact that they were selling insurance. They thought they were just taking bets, like Ladbrokes (but even Ladbrokes does not itself take a position on a bet). Indiscriminate sale of credit default swaps (CDSs) is the principal source of AIG's problems.

Moral Hazard and Credit Default Swaps

- ◆ It is like allowing strangers to buy insurance on someone's house, creating an incentive for them to set fire to it and collect the insurance. Or a pirate buying insurance on someone else's ship from Lloyds and then sinking it to collect the insurance. This is the well known problem of moral hazard in insurance that every insurance company should know and avoid.
- ◆ But AIG sold many times more CDSs on Lehman Brothers than Lehman Brothers had bonds outstanding (reportedly much more than ten times). Many purchasers of such CDSs were simply gambling on a Lehman Brothers failure. It would have been better if these purchasers had no influence on whether Lehman Brothers would go under or not. Or if AIG does not take a position itself, merely squaring those who bet that Lehman Brothers would fail with those who bet Lehman Brothers would survive, letting the market determine the odds.

Moral Hazard and Credit Default Swaps

- ◆ Unfortunately, that is not the case. AIG took on the bets itself, and many of the purchasers of the CDSs had the power to help force Lehman Brothers under, for example, by massively shorting its stocks or bonds, so that Lehman Brothers would be effectively prevented from accessing the capital and credit markets.
- ◆ The total amount of all CDSs outstanding on Lehman Brothers at the time has been estimated to be approximately US\$500 billion, relative to the total amount of the underlying bonds outstanding of only US\$50 billion. In other words, the insurance companies collectively sold US\$500 billion worth of insurance on bonds that are only worth US\$50 billion, approximately 10 times.

Moral Hazard and Credit Default Swaps

- ◆ In retrospect, even considered as insurance, the CDSs on Lehman Brothers were not priced correctly. The price of the CDSs did not reflect adequately the probability of its failure, given its high degree of leverage and potential liabilities, and moreover did not take into account adverse selection—people buy insurance only because they have reason to expect that there is a high probability that they will be able to collect the insurance.

Moral Hazard and Credit Default Swaps

- ◆ Furthermore, the insurance industry is normally regulated by the government to ensure that the insurance companies have adequate reserves to pay the claims if and when they arise. In the case of CDSs, adequate insurance reserves were never properly established. That is one reason why AIG is in so much trouble today.
- ◆ One reason why the CDSs were not regulated as insurance is because the U.S. Congress passed legislation in 2000 (H. R. 5660 ``Commodity Futures Modernization Act of 2000"), declaring that CDSs were neither insurance nor gaming, thus effectively enabling CDSs to escape possible government regulatory supervision altogether.

Moral Hazard and Credit Default Swaps

- ◆ In retrospect, the availability of CDSs on Lehman Brothers actually increased the probability of failure of Lehman Brothers rather than decreased it, thus increasing rather than decreasing the overall riskiness of the financial sector and the economy. It is therefore not necessarily true that financial derivatives reduce risks.
- ◆ CDSs, if sold indiscriminately, can provide the instruments for a form of predatory speculation—hedge funds and other investors seek relatively weak firms, buy their CDSs and drive them into bankruptcy by selling short (often naked) their bonds and stocks.

Moral Hazard and Asymmetric Incentive Compensation

- ◆ The incentive compensation schemes at most U.S. corporations and at many investment funds are asymmetric in the sense that the executive/asset manager stands to reap huge rewards tied to the degree of success over and above a certain benchmark (through stock options and “carry interests”) but does not share in the losses (beyond possibly losing his or her job).
- ◆ These stock options and “carry interests”, which allow executives and asset managers to share the upside but not the downside, also create moral hazard and encourage corporate executives and asset managers to take excessive risks.

Moral Hazard and Asymmetric Incentive Compensation

- ◆ Stock options, which provide only upside but no downside for the option grantees, are ideal for venture capital and for start-ups because these are inherently high-risk ventures but with no real down-side that is not already expected and will be shared by investors and executives alike. However, stock options may not be appropriate for mature enterprises because there may be a significant downside for the owners and shareholders of the firm which may not be shared by the executives granted the stock options.

Moral Hazard and Asymmetric Incentive Compensation

- ◆ The high management fees, including the so-called “carry interests,” charged by the managers of investment funds, have the effect of causing these asset managers to take excessive risks because they would share a significant proportion of the upside but not the downside.
- ◆ Typically the fee structure of investment funds (including hedge funds and private equity funds) is 2 plus 20—2 percent of the value of assets under management plus 20% of the returns above a certain threshold, but the carry interest can go all the way up to as high as 40 percent. This incentive scheme encourages risk-taking on the part of the asset managers because they stand to gain significantly if they make it big but lose very little if their investment strategies fail.

Moral Hazard and Asymmetric Incentive Compensation

- ◆ “Heads I win, tails you lose” is neither effective nor efficient as a method of incentive compensation for corporate executives and asset managers—it greatly encourages moral hazard and reckless behaviour.
- ◆ To be fair, there are asset managers who voluntarily set a ceiling to the upside of their fees, thus reducing their own incentive to take excessive risks.

Moral Hazard and Asymmetric Incentive Compensation

- ◆ Moreover, stock options are frequently based on short-term performance of the common stock in the stock market. Incentive compensation of senior executives should not be based on short-term results but instead should be based on long-term performance of the corporation, including ideally the performance over a period after their retirement from the corporation. In this way they will have the incentive not to pursue quick short-term profits but to invest for long-term sustainable earnings as well as to help choose their successors carefully.
- ◆ An alternative is to require the executives/managers to own outright shares in the corporation or the investment fund that constitute a high proportion of their personal net worth, through recourse loans if necessary. That will help align their interests with those of the ordinary shareholders/investors and discourage moral hazard and excessive risk-taking.

Moral Hazard and “Too Big to Fail”

- ◆ Implicit guarantees of banks and financial institutions considered “too big to fail” by governments encourage moral hazard on the part of the large banks and financial institutions. They may take excessive risks with the belief that they will not fail and will not be allowed (by the governments) to fail.
- ◆ No firm, financial or otherwise, should be allowed to become too big to fail. For example, if a bank fails, the depositors should be protected insofar as there is deposit insurance. The secured creditors are compensated in whole or in part by the collateral they already hold. The other creditors presumably have bought the debt of the bank on their own free will, can take the losses. And the shareholders, who will be in the last position, may wind up with nothing. But there is no reason for the bank not to continue operating, under new management and ownership.

Moral Hazard and “Too Big to Fail”

- ◆ A firm is “too big to fail” only if it is heavily leveraged. If it is not heavily leveraged, it can be simply allowed to fail (the shareholders will lose but another firm or investor can take over its functions).
- ◆ It is the excessive leverage of a bank that may make it too big to fail—it may owe other banks and financial institutions, bondholders and other creditors too much money. If excessive leverage is strictly limited, and the diversified exposure requirement is strictly enforced, that is, a bank cannot be overly exposed to a given customer (with a group considered as a single customer), no bank should be able to become too big to fail.
- ◆ The United States, the largest provider of international liquidity, is itself in crisis, but it is really “too big to fail.”

Defects in Institutional Design

- ◆ Defects in institutional design can be identified in the following areas:
- ◆ (1) The locus of regulation and supervision;
- ◆ (2) The financial accounting standards;
- ◆ (3) The form of securitisation of loans; and
- ◆ (4) The lack of specialisation of banks.

Defects in Institutional Design: The Locus of Regulation and Supervision

- ◆ There is no universal agreement on how banks and financial institutions should be regulated and supervised. There are two separate issues: first, whether commercial banks and commercial banking activities are better regulated and supervised by the central bank or by a separate agency and second, whether all financial activities of any kind (commercial banking, investment banking, securities firms and markets, and insurance) should be regulated and supervised by a single, unified regulatory agency.

Defects in Institutional Design: The Locus of Regulation and Supervision

- ◆ The regulation and supervision of commercial banks by a financial services regulatory agency outside of the central bank has not proved to be a success in the United Kingdom. This is because the central bank has valuable, continuous, real-time information on the state of the commercial banks through its funds clearing and settlement system that is not readily apparent in periodic audits carried out by an independent regulatory agency, and that ultimately only the central bank is able to assume the crucial role of “the lender of last resort.”

Defects in Institutional Design: The Locus of Regulation and Supervision

- ◆ In the United Kingdom, the responsibility of regulating and supervising the commercial banks has been given back to a unit within the Bank of England, the central bank after the global financial crisis of 2007-2009.
- ◆ In the United States, regulation and supervision of banks are still not unified, notwithstanding the global financial crisis. The responsibilities are divided among the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of Currency (for national banks) and the Banking Commissioners of the 50 individual states. The Federal Reserve Board has de facto, if not de jure, assumed the responsibility of the regulation and supervision of the major commercial banks.

Defects in Institutional Design: The Locus of Regulation and Supervision

- ◆ Such diffusion and division of responsibilities have prevented the regulators and supervisors from acting decisively in a timely manner when crises arise.
- ◆ Moreover, the regulation and supervision of (non-deposit-taking) investment banks, securities firms and insurance companies are frequently scattered among different agencies with little formal coordination. This may work in a Glass-Steagall environment but is woefully inadequate when the Glass-Steagall Act no longer applies, that is, when banks or bank-holding-companies can enter the full line of financial service businesses.

Defects in Institutional Design: The Financial Accounting Standards

- ◆ The Financial Accounting Standards adopted in the developed economies, especially in the United States, have prevented the early identification of the excessive leverage and have exacerbated the global financial crisis once it began.
- ◆ First, off-balance-sheet activities of banks as well as other publicly listed corporations are a major cause of the financial crisis. They should be prohibited outright except under the most special circumstances and only with explicit prior written approval of the regulators/supervisors/auditors. All contingent liabilities and significant exposures should be fully disclosed.

Defects in Institutional Design: The Financial Accounting Standards

- ◆ Second, mark-to-market rules may exacerbate a crisis because of the uncertainty and volatility in the financial markets. By marking to market, a financial institution may fall short of the capital requirements and be forced to sell assets and contract. Selling assets and contraction may drive asset prices lower, requiring further marking down to market, which in turn may lead to further selling of assets and contraction. It should be possible to suspend mark-to-market rules when market conditions are too volatile and the market prices fail to reflect long-term underlying values. (Irrational panic can be just as likely as irrational exuberance!)

Defects in Institutional Design: The Financial Accounting Standards

- ◆ Mark-to-market rules may also create problems and confuse investors when valuation is done not with reference to arms-length open market transactions but through an untested model. As the value of financial derivatives, especially customised ones, rises as a proportion of total assets, their precise valuation will have a material impact on the balance sheet of the firm.
- ◆ Mark-to-market rules should not be applied to long-term investment, regardless of whether they result in an accounting gain or loss—for example, a long-term direct investment by IBM Corporation in Japan should not have to be written up and down based on the current end-of-quarter Yen-Dollar exchange rate.

Defects in Institutional Design: The Financial Accounting Standards

- ◆ When market prices are volatile, marking long-term assets to reflect short-term price fluctuations misleads rather than informs the public investors. Moreover, they may lead to either false alarms or a false sense of security. (This is similar to the distinction between the accounting of hold-for-trade and hold-for-investment assets.)
- ◆ Firms should be given a one-off choice on whether to adopt the mark-to-market rule on any given investment, a choice which should be left unchanged for the life of the investment. Apparently such a change in the rules has already taken effect in some jurisdictions since 2008.

Defects in Institutional Design: The Financial Accounting Standards

- ◆ Third, quarterly reporting imposes a significant cost to publicly listed firms but the substantive information content of quarterly reports is generally very low compared to annual and semi-annual reports.
- ◆ Quarterly reporting does nothing other than putting pressure on executives to focus on short-term performance, which may actually work against the interests of the shareholders. In any case, an investor always has a choice not to invest in companies that do not report quarterly.
- ◆ Quarterly reporting should therefore be made optional rather than mandatory for publicly listed companies.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ Long-term fixed-rate loans, especially home mortgage loans, need to be securitised and sold to long-term investors because commercial banks do not have sufficient long-term fixed-rate deposits to meet the demand for such long-term fixed-rate loans. If commercial banks make and keep long-term fixed-rate loans, they will have a maturity mis-match in their assets and liabilities which may eventually result in a similar debacle as the savings and loan associations in the early 1980s.
- ◆ The sub-prime mortgage loan crisis in the U.S. arose not so much because of securitisation of the home mortgage loans per se, but rather because these mortgage loans were not securitised in the right way. (This is in addition to the moral hazard of the originating lender problem discussed above.)⁷⁶

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ There are two routes to the securitisation of long-term loans--principally long-term (up to 35 years) fixed-rate owner-occupied home loans backed by first mortgages—which we can call direct securitisation and indirect securitisation respectively.
- ◆ Direct securitisation takes the form of long-term bonds issued to the public by a financial institution against a specific package of qualified long-term loans (assets) meeting certain specifications as collateral. The loans (assets) are then owned by the purchasers of these bonds, who will receive the scheduled payments of interest on and repayments of the principals of these loans in the form of bond interest and principal repayments. The bonds may also be guaranteed by a financial institution.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ In the case of the U.S., the issuing and/or guaranteeing financial institution is often either Fannie Mae or Freddie Mac, both quasi-sovereign financial institutions. The bondholders, in the absence of explicit guarantees, primarily look to the specific package of loans as the underlying collateral.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ Indirect securitisation takes the form of long-term bonds issued directly to the public by a financial institution, the primary business of which is to purchase qualified long-term loans meeting certain specifications (with the maturities of the bonds matching the maturity of the loans).
- ◆ The purchasers of the bonds look primarily to the financial institution for the payment of bond interest and the repayment of the bond principal. The bonds themselves are not specifically collateralised even though the long-term loans are part of the overall assets owned by the financial institution.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ The financial institution uses the proceeds from the bonds to purchase these qualified loans from originating mortgage lenders. The loans are owned by the financial institution. The borrowers pay the interest and any repayment of principal on the loans to the financial institution, sometimes through the originating lenders who may be retained as servicing agents for a fee, and the financial institution pays the bondholders, regardless of whether it has been paid by the borrowers.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ In most instances, the mortgage loans financed through securitisation are for owner-occupied residential housing, with restrictions on size and maximum loan value, among other requirements.
- ◆ Owner-occupied residential mortgage loans are different from other mortgage loans because their default rate is much lower than that of non-owner-occupied residential mortgage loans taken out by investors and speculators. It is therefore possible, under indirect securitisation, for the financial institution issuing the bonds to bear the risks of loan defaults.
- ◆ It is justifiable to have a social policy favouring owner-occupied home-ownership but not favouring investment in or speculation on non-owner-occupied residential property on the grounds that it promotes social harmony, security and stability.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ There are several advantages of indirect securitisation over direct securitisation.
- ◆ First, the bonds issued will have quasi-sovereign status if the financial institution is established as a state policy bank (which was originally the case for Fannie Mae and Freddie Mac) and will therefore be able to carry a lower rate of interest. The lower rate of interest will also benefit the borrowers of the owner-occupied residential mortgage loans.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ Second, there is pooling of the risks of default on the mortgage loans under indirect securitisation, so that the risks are spread and shared by purchasers of successive issues of bonds of the bank, whereas under direct securitisation, there is no pooling across successive packages of loans. The actual risks and returns to purchasers of directly securitised mortgage-loan-backed securities can therefore vary significantly from package to package.
- ◆ Third, if the originating mortgage lenders are required to assume a residual liability of say between 5 and 10 percent of the principal of the mortgage loans they originate (which is good for controlling moral hazard), it is much easier to enforce with the financial institution as the purchaser of the mortgage loans rather than a group of bond investors.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ Fourth, in the event of a default by one or more borrowers on their mortgage loans, since the mortgage loans are owned directly by the financial institution, it is much easier to have a work-out between the borrower and the bank, through the servicing agent, under indirect securitisation. Under direct securitisation, it is much more difficult and costly for the current owners of the bonds to negotiate a work-out with the individual non-performing borrowers. While direct securitisation per se is not itself to be blamed for the crisis, it greatly complicates the resolution and prolongs the negative impacts of the crisis. Many non-performing mortgage loans in the U.S. remain to be worked out between the borrowers and the current owners of the mortgage loans.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ Fifth, under indirect securitisation, there will also be greatly reduced transactions costs and there is no need to rely on credit rating agencies to rate each specific package of mortgage loans or on investment banks to package and promote and market the mortgage loans to the investing public.
- ◆ Sixth, for the investors and potential investors, the market for these indirectly mortgage-backed bonds will be much bigger as well as more liquid.

Defects in Institutional Design: The Form of Securitisation of Loans

- ◆ One possible complication is whether there should be a pre-payment penalty for these mortgage loans (there should be, in order to keep the transactions cost and hence the rate of interest low), but the same problem exists whether the mortgage loans are directly or indirectly securitised.
- ◆ The only disadvantage of indirect securitisation is that the investment banks will no longer be able to earn fat fees for securitising these mortgage loans.

Defects in Institutional Design: The Specialisation of Banks

- ◆ Should banks that accept retail deposits from the general public be allowed to engage in proprietary trading in securities for their own accounts? This issue was considered in the recent discussion of financial reform legislation in the United States in connection with the “Volcker Rule.”
- ◆ In principle, it should be fine if the proprietary trading is done with a bank’s own resources and the amount at risk is subtracted from the bank’s capital as far as the calculation of the bank’s capital adequacy is concerned. The depositors’ funds are not to be used at all in the proprietary trading.

Defects in Institutional Design: The Specialisation of Banks

- ◆ The problem arises when there is potential for a conflict of interest (e.g., the bank's proprietary trading unit selling a security that the bank's trust or private banking department is buying on behalf of a bank customer) and when there is illegal use of information on the bank's customers by the bank's proprietary trading unit in its trading. Even though there is supposed to be a “Chinese Wall” separating the proprietary trading unit from the commercial banking unit but experience tells us that these “Chinese Walls” can become very porous.

Defects in Institutional Design: The Specialisation of Banks

- ◆ The same consideration applies to a bank conducting both investment banking and commercial banking activities at the same time.
- ◆ Conflicts of interest can easily arise. For example, the investment banking unit may try to raise capital for a corporation to repay a loan to the commercial banking unit without fully disclosing the true conditions of the corporation. For another example, the commercial banking unit may extend a loan to enable a customer to buy securities being marketed by the investment banking unit.

Defects in Institutional Design: The Specialisation of Banks

- ◆ These problems can be avoided if banks specialise. But the most compelling argument is that there does not seem to be any real synergy between investment banking and commercial banking if all the laws and regulations on avoidance of potential conflict of interest and sharing of information are properly followed. So why put them together?

Defects in Institutional Design: The Specialisation of Banks

- ◆ While many banks are attempting to become whole banks or universal banks, one should also consider the establishment of specialised banks with special missions. These banks can be regulated and supervised differently from the other banks.
- ◆ For example, banks established to promote a particular government policy, such as Fannie Mae and Freddie Mac in the United States, should not be privatised, even in part. This is because once a policy bank is privatised, even in part, the private shareholders will demand short-term profits and returns which may not be consistent with the mandate and mission of the policy bank.

Defects in Institutional Design: The Specialisation of Banks

- ◆ If Fannie Mae and Freddie Mac were not publicly listed, they would not have been subject to the pressure of shareholders demanding a financial return, and might therefore have been more prudent in their expansion and acquisition of loans. This might have helped avert the financial crisis or at least reduce its intensity.
- ◆ The senior management of such policy banks should also be compensated differently from those of private, for-profit, banks so as to reduce the incentive to take excessive risks.

Defects in Institutional Design: The Specialisation of Banks

- ◆ It is also possible to envisage the emergence of a new type of “narrow” bank, or “transactions” only bank, that Prof. James Tobin, Nobel Laureate in Economic Sciences, once advocated.
- ◆ Such a bank only takes deposits, but does not make loans. It can offer its customers a debit card but not a credit card. It offers interest-bearing current deposit accounts as well as term deposit accounts. It invests its deposits entirely in central government securities (hence no credit risk) of appropriately matching maturities (hence no asset-liability maturity mismatch risk). Even deposit insurance should not be required for this type of bank.

Defects in Institutional Design: The Specialisation of Banks

- ◆ As such a bank has virtually no risk, it should therefore be subject to only minimal capital and reserve requirements. Its assets are entirely invested in central government securities and hence will also have the highest possible liquidity. (So perhaps a 2% capital requirement and a 2% reserve requirement should be sufficient.) It may have to meet a liquidity requirement based on the volume of transactions cleared every day.

Defects in Institutional Design: The Specialisation of Banks

- ◆ The postal savings banks of many countries can be quickly transformed into such “transactions only” banks by basically allowing the use of cheques and electronic transfers of funds on their existing accounts.
- ◆ The “transactions only” banks can provide a secure depository institution and an efficient, low-cost transactions account for the average citizen.
- ◆ Such banks, appropriately regulated and supervised, should be immune from any systemic crisis.

What Caused the European Sovereign Debt Crisis?

- ◆ The source of the European sovereign debt crisis is the accumulation of public debt, incurred to support a continuing series of government budget deficits, to a level that is beyond the servicing capacity of the individual country.
- ◆ Moreover, it is important to make a distinction between internal debt and external debt. Internal debt is debt owed by a country to its own citizens and firms. External debt is debt owed by a country to non-nationals.

What Caused the European Sovereign Debt Crisis?

- ◆ If the public debt were mostly internal, such as in Japan, which has a public debt to GDP ratio in excess of 200 percent, the problem is manageable. Internal debt is a little like debt within the same family. The son borrows from the father. When the father demands repayment from the son, the son goes to the mother and asks for money to repay the father. The mother asks the father for money. Father gives money to mother, mother gives money to son, and son repays the father. This completes the circle. This arrangement can continue more or less indefinitely, especially if the rate of interest is low, as long as the money stays within the family.
- ◆ However, if the debt is external to the family, this recycling breaks down. Debt repayment then becomes a real burden for the family.

What Caused the European Sovereign Debt Crisis?

- ◆ As long as the debt is internal to a country, the government can issue new debt to its citizens and firms and repay the old debt with the proceeds. This process can continue indefinitely if the domestic citizens and firms have confidence in the government, and especially if the nominal interest rate is low. (It can also increase taxes and repay the old debt with the additional taxes collected.)
- ◆ However, this process breaks down if the debt is held externally, by non-nationals. In this case, net real resources must flow out of the country.

What Caused the European Sovereign Debt Crisis?

- ◆ Unfortunately, in the case of Greece, much of the debt is external. The situation is therefore not sustainable.
- ◆ The other option of solving the problem through printing more money is not available to Greece, because it does not have the authority to issue Euros (unlike the United States, which can increase the supply of U.S. Dollars at will).
- ◆ The solution for Greece is therefore limited to severe austerity or outright default (which implies exit from the European Union).
- ◆ It does not help that there are many speculators speculating on an eventual Greek default. The indiscriminate sale of credit default swaps (CDSs) on Greek debt, and for that matter on the debts of other members of the Euro Zone, to speculators who do not own the underlying bonds, exacerbated an already bad situation.

What Caused the European Sovereign Debt Crisis?

- ◆ The Euro Zone authorities should probably have stepped in more decisively and forcefully to maintain confidence in the Euro and Euro Zone debt. Confidence, once lost, is extremely difficult and costly to restore.

What Lessons Can We Learn?

Appropriate Monetary Policy

- ◆ A permanent policy of easy money will create asset price bubbles and fuel inflation, especially in a financially mature economy. Rates of interest, especially lending rates, should be kept positive in real terms most of the time.
- ◆ However, in an economy without a stock or security market, the total value of transactions, for a given level of real GDP, is lower than the total value of transactions in an economy in which there are the financial transactions of buying and selling stocks and securities in addition to the real transactions. As an economy undergoes financial deepening, the rate of growth of money supply will have to exceed the rate of growth of real GDP even as the rate of inflation of the prices of goods and services remains near zero.

What Lessons Can We Learn?

Restrain Irrational Exuberance

- ◆ The financial regulatory agencies should monitor asset (securities and property) markets and take appropriate measures to prevent asset price bubbles from becoming too big.
- ◆ Instruments include controlling the loan to equity ratios and loan ceilings in real estate markets and margin requirements in stock markets. Other instruments include the pricing, quantity and timing policies of land sales and the pace of initial public offerings as well as more opportunistic additional public offering through the use of “shelf registration.” Stamp, transaction and capital gains taxes can also play a role in reducing the expected net after-tax rate of return on speculative investments.

What Lessons Can We Learn?

Restrain Irrational Exuberance

- ◆ The fundamental idea is to try to influence and modify long-term asset price expectations. If additional supplies are expected to be forthcoming in the future, the asset price bubble cannot become too big.

What Lessons Can We Learn?

Regulation is Essential

- ◆ Markets do not and cannot function well automatically on their own. The incentives are too strong for firms, if left alone, to try to monopolise markets, to collude, or to otherwise benefit themselves at the expense of other market participants (e.g., insider trading, front running, etc.). Excessive leverage cannot be left to self-regulation. Information asymmetry can be reduced only through regulatory measures (there is no reason for an investor to disclose information voluntarily to one's potential competitors in the financial markets). Moral hazard must also be explicitly discouraged and controlled.
- ◆ Strengthened financial regulation and supervision is essential to avoid a recurrence of another financial crisis of similar magnitude to the current global financial crisis.

Strengthening Financial Regulation and Supervision

- ◆ What measures should be taken by financial regulatory and supervisory agencies to strengthen financial regulation and supervision?
- ◆ (1) Restrict excessive leverage;
- ◆ (2) Ensure competitiveness of markets; and
- ◆ (3) Control moral hazard.

Strengthening Financial Regulation and Supervision

- ◆ If any bank or financial institution cuts corners, its costs will be lower and its profits will be higher. If the regulator allows a bank or financial institution to cut corners, other banks will be forced to follow in order to compete.
- ◆ Thus, in order to reduce systemic risk, financial regulation and supervision must be uniformly enforced. It is most important for the regulator not to allow bad practices gradually become industry-wide standard practices. Regulations must be clear and enforcement must be strict. Otherwise all the grey areas will appear white in no time.
- ◆ The regulatory agencies should always remember that their primary responsibility is the protection of consumers (depositors and borrowers), creditors and investors, ensuring the fairness and efficiency of the markets, and the security and stability of the financial system as a whole. It is not their responsibility to assure the profitability of the firms they are charged to regulate.

What Lessons Can We Learn?

Restrict Excessive Leverage

- ◆ Because of the negative externalities generated by excessive leverage, there is public interest in controlling the degree of leverage of firms, especially financial institutions. Excessive leverage should therefore be tightly controlled. Capital adequacy should be strictly monitored.
- ◆ A firm is “too big to fail” only if it is heavily leveraged. If it is not heavily leveraged, it can be simply allowed to fail (the shareholders will lose but another firm or investor can take over its functions).
- ◆ There must be restrictions on the degree of leverage in the economy, especially for the financial sector.
- ◆ Limits on leverage is easy to enforce and difficult to circumvent provided that off-balance-sheet activities are not allowed.

What Lessons Can We Learn?

Ensure Competitiveness of Markets

- ◆ The regulatory and supervisory agencies should ensure competitiveness of the financial markets by reducing information asymmetry, increasing disclosure and transparency, restricting the dominant positions of market participants and prevent collusion.

What Lessons Can We Learn?

Reduce Information Asymmetry

- ◆ The public will be much better informed if off-balance-sheet activities are not allowed for publicly listed firms, including all financial institutions. This will also reduce leverage, improve corporate governance, and avoid negative surprises.
- ◆ The practice of “shadow banking,” which leads to undisclosed “excessive leverage” and increases significant systemic uncertainty should be prohibited—the banks should either make a direct loan to a corporation, or provide an explicit guarantee on the bonds and notes issued by the corporation, all of which will be explicitly on the balance sheet of the Bank. At the current stage of financial development in many developing economies, allowing “shadow banking” will greatly increase systemic risk in these economies.

What Lessons Can We Learn?

Enhance Disclosure and Transparency

- ◆ The introduction of the many new financial instruments has created additional problems for the regulators— instead of reducing and sharing risks, they concentrate and magnify risks and increase overall systemic risk.
- ◆ Many of these complex and non-standard financial instruments are priced and traded only privately (e.g., accumulators) and not on open public markets and exchanges. There is a crying need for simplification and standardization of financial derivatives and for them to be traded only on established and publicly regulated open exchanges. This assures some degree of transparency and fairer pricing, safeguards against market manipulation, and helps to reduce counter-party and systemic risks.

What Lessons Can We Learn?

Restrict Dominant Positions

- ◆ Dominant positions (e.g., over 5% share of any specific traded financial instrument) in any financial markets should be required to be disclosed, as well as any subsequent increase or decrease in such positions. In these instances, the final beneficial owners should be disclosed to avoid the use of multiple names and accounts to circumvent the disclosure requirement.
- ◆ For certain instruments, there should be an upper limit to the market share that can be held by a single person or entity.

What Lessons Can We Learn?

Control Moral Hazard

- ◆ Moral hazard should be controlled and discouraged by the regulators, so that any potential gain is accompanied by potential pain, reducing excessive risk-taking on the part of all market participants.
- ◆ This includes the regulation and supervision of the originating mortgage lenders, credit rating agencies, insurance companies and their products and business practices as well as the degree of leverage of firms, including financial institutions and hedge funds. The goal is to reduce the incentive to take “hidden actions” and/or excessive risks.

What Lessons Can We Learn?

Control Moral Hazard

- ◆ Credit Default Swaps (CDSs) should be sold to only bona fide owners of the underlying bonds. And once the original owners sell the bonds, they should not be allowed to keep the CDSs—they will either have to be sold, with the bonds, to the new buyer, or they should be returned to the insurance company for a refund, if any.

What Lessons Can We Learn?

More Symmetric Incentives

- ◆ Incentive compensation of senior executives of firms and asset managers should be based on long-term performance of the corporation/fund, including the performance over a period after their retirement from management.
- ◆ Stock options which provide only short-term upside but no down-side should be used very sparingly. Instead, senior executives/managers should be encouraged to own equity (through recourse loans if necessary) in the corporations/funds they manage.

What Lessons Can We Learn?

Focus on Long-Term Performance

- ◆ Corporate management and public investors should be encouraged to focus on long-term rather than short-term performance. Incentive compensation based on short-term results has led firms and managers to pursue quick short-term profits rather than invest for long-term sustainable earnings.
- ◆ Financial engineering can create quick short-term profits but often fail to add any lasting real value in terms of GDP and employment.

What Lessons Can We Learn?

Do Not Allow “Too Big to Fail”

- ◆ No firm should be allowed to become too big to fail. It is the excessive leverage of a firm that may make it too big to fail—it may owe other banks and financial institutions too much money. If excessive leverage is curbed, no firm, including financial institution, should be able to become too big to fail.
- ◆ More stringent regulation of “Systematically Important Financial Institutions (SIFIs)” and “Globally Systematically Important Financial Institutions (GSIFI)”.

What Lessons Can We Learn?

Improve the Institutional Design

- ◆ The risk of systemic failure of the financial sector can be reduced by appropriate choices of features of its institutional design. Here we consider four major areas where improvement is possible:
 - ◆ (1) The locus of regulation and supervision;
 - ◆ (2) The financial accounting standards;
 - ◆ (3) The method of securitisation of loans; and
 - ◆ (4) The specialisation of banks.

What Lessons Can We Learn?

The Locus of Regulation and Supervision

- ◆ Regulation and supervision of (retail deposit-taking) commercial banks are best lodged in a division within the central bank. In any case, close coordination between the central bank and any separate banking regulatory and supervisory agency is essential.

What Lessons Can We Learn?

The Locus of Regulation and Supervision

- ◆ While there are calls for the return of the Glass-Steagall Act in the United States, it does not appear likely at this juncture. However, with whole or universal banking, it is necessary that the different regulatory and supervisory agencies—banking, securities and insurance—examine financial institutions jointly to deter the shifting of assets from one unit to another in order to avoid regulatory and supervisory scrutiny and worse, to hide the true state of affairs.
- ◆ Unless there is a determination to bring back Glass-Steagall Act or its equivalent, unified regulation and supervision is absolutely essential and urgent.

What Lessons Can We Learn?

The Financial Accounting Standards

- ◆ The first major regulatory reform on financial accounting standards should be the prohibition of off-balance-sheet activities of banks as well as other publicly listed corporations, except under the most special circumstances.
- ◆ Second, mark-to-market rules should be evaluated as to under what circumstances they should be mandatory and under what circumstances they can be optional. The objective is to present as true a picture as possible and to avoid misleading the investors, especially at times of irrational exuberance or irrational panic.
- ◆ Third, quarterly reporting should be made optional for publicly listed firms. Investors can decide whether they will invest in firms that do not report quarterly.

What Lessons Can We Learn?

Improve the Institutional Design

- ◆ Indirect securitisation is the preferred route to go to finance long-term fixed-interest-rate residential mortgage loans.
- ◆ The “Volcker Rule” protects the interests of the retail depositors and should be adopted.
- ◆ Policy banks should not be privatised, even in part, and in particular should not be publicly listed, so as to avoid shareholders’ pressure for quick returns and potential conflict between the interests of the shareholders and the policy bank’s public policy mission.

What Lessons Can We Learn?

The European Sovereign Debt Crisis

- ◆ Early and decisive action is necessary in any financial crisis. The most important objective is to maintain confidence and promote positive expectations of the future.
- ◆ Expectations, which are often self-fulfilling, are difficult to change. Changing negative expectations to positive expectations require decisive action with a large impact. For example, the mere announcement of the four trillion Yuan economic stimulus programme rolled out by the Chinese Government in November of 2008 helped to maintain confidence and prevented expectations from becoming overly negative.
- ◆ Fiscal contraction at a time of recession feeds negative expectations about the future. It is better to have a short-term fiscal expansion to promote the resumption of growth, coupled with a longer-term plan for achieving fiscal balance in the long run.

Concluding Remarks

- ◆ In order to avoid future financial crises and to reduce their potential intensity if they occur, strengthened regulation and supervision as well as improving the institutional design are necessary.
- ◆ Nations should try to put their fiscal house in order for the long term by balancing recurrent expenditure with recurrent revenue, but promoting growth and employment, for example, through public infrastructural investment, should take precedence in a serious recession.