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The Aftermath of the Financial Crisis and Reforming the International Financial System

By Geoffrey Bell

Setting the Scene

- World is experiencing the biggest recession since the Great Depression of the 1930's. The IMF is forecasting a drop in output in 2009 and then only a slow recovery.

- View is that China, India and Brazil will emerge with modest levels of growth but better than the industrial counties.

- Key point is that the recovery in the US, UK, Western Europe and Japan will be slow like a Nike "swoosh" or even an extended "L". This is because of an increase in savings, slower growth of consumption, high levels of unemployment and tighter monetary conditions.

- Governments have spent trillions of dollars stimulating their economies (US and UK will have budget deficits equal to 12-14% of GDP this year) and central banks have been pumping money into the system to add liquidity. This is a strong reason why "green shoots" of recovery are beginning to appear across the globe.

- The "Great Recession" may end in the third or fourth quarters of 2009 in the US and later in Europe. There is no doubt that the slowdown is moderating but the strength of the recovery is in doubt. The safest course is to assume that the world economy will enter a slow period of growth by any recent historical standards.

- The risk is that interest rates rise because of government demands to raise money and this further slows the recovery.

What caused the crisis?

- Started as a result of the housing bubble in the United States. As prices rose this increased household wealth which enabled easy borrowing at very low interest rates.

- The housing bubble was amplified by a belief that house prices only rise, a deterioration of lending standards especially with the securitization of complex mortgage instruments and with very little supervision by regulators.

- Credit risks became more and more under priced especially after 2004 which persuaded bankers to look for higher yield and hence risk areas.

- This triggered leverage on a massive scale with bank and near-bank ratios soaring to unprecedented levels. Leveraged was placed on leverage through securitization culminating in CDO2 and similar instruments.

- All of this became global with even small towns in the Artic Circle buying exotic assets which turned out to be illiquid when the downturn came. Banks across the globe bought assets enabling the dance to continue.

- Risk management techniques were woefully inadequate in financial institutions and supervisors were extremely lax. Also, incentive schemes in financial institutions encouraged excessive risk taking.

- This growing bubble was encouraged by low interest rates blamed on excessive savings in China while investors believed the "Super AAA" labels on securities given by the Rating Agencies.

- The crisis erupted in the US as the housing bubble burst then assets previously thought of as liquid became unsaleable and the panic escalated at lightening speed culminating in the failure of hedge funds (Bear Stearns) and, above all, in the bankruptcy of Lehman Bros.

- The economic impact was much bigger then anyone had thought possible and spread to most parts of the world very fast. Mark to market accounting rules made matters worse and a perfect financial and economic storm ensued.

- By 2008 virtually all industrial countries were in recession for the first time since WWII and banks essentially stopped lending. Confidence disappeared and is only being rebuilt slowly.

- So a financial collapse became an economic collapse with both feeding on each other by late 2008 and in 2009.

<u>What next?</u>

a) Financial Market and Regulatory Repair:

- This will be a period of intense regulatory activity to try and ensure that such a collapse does not happen again. Moreover, this will take place around the world but led by the US, UK and Western Europe.

- Obviously, the exact form of new supervision is still in the process of being developed but some elements are very clear:

a) Capital levels will be increased for financial institutions at the cost of lower profitability.

b) Leverage ratios are being lowered and it will not be possible for investment banks and other financial institution the other financial institutions to have leverage ratios of 30 to 40:1.

c) Liquidity levels and the management of liquidity are being raised.

d) The use of off-balance sheet vehicles (SIV's) are being banned or much stricter standards are being imposed on their use.

e) Hedge funds will be registered and supervised.

f) Better qualified Board of Directors for banks are being required with individuals that have knowledge of finance.

- The supervision of financial institutions is being greatly strengthened. This may require the consolidation and streamlining of the hodge-podge of regulatory bodies in the US. Also, central banks will be given responsibility for "financial stability" and be able to intervene in any financial institution (in their own country) if they feel that it is threatening the stability of the system.

- Supervisors will explicitly try to reduce the pro-cyclical behavior of financial firms by encouraging dynamic provisioning or capital buffers.

- Supervisors will decide what is the best entity to regulate a particular institution not vice versa as in the case of AIG.

- The Basel II framework will be greatly strengthened with Pillar II being the key determinate of capital and the use of models will be downgraded.

- Above all, there will be an implicit or even an explicit distinction between banks that are systemically important (too big to fail) and the others. These banks will be subject to continuous supervision and restricted on their leverage and trading activities. The rest will be allowed to fail if they find themselves in trouble.

- There may be an effort to reduce the size of banks and institutions deemed too big to fail so that they too can be allowed to disappear at some stage.

- A major effort will be made to co-ordinate supervisory activities amongst the international regulators through the Financial Stability Board and the Bank for International Settlements. This will be difficult given that so many financial institutions are global in life but are definitely domestic in death. Here the domestic authorities argue that if they have the responsibility in bankruptcy why not in life. This process will be evolving over the next years.

b) <u>The US Example of Financial Reform</u>

- The future shape of the US financial regulatory system is critical both given its size and the fact that the crisis emanated from the US. Inevitably, the details are still subject to change but Secretary of Treasury Geitner's testimony to Congress on March 26th is important as is Paul Volcker's Group of 30 Report "Financial Reform A Framework for Financial Stability" published in December 2008.

- Secretary Geithner makes a major point that investment banks (the biggest like Goldman Sachs and Morgan Stanley are now commercial banks), large insurance companies, finance companies and the GSE's were subject to only limited oversight on a consolidated basis and Federal law allowed many institutions to choose among regulatory regimes for consolidated supervision. As he said "the days when a major insurance company could bet the house on credit default swaps with no one watching and no credible banking to protect the company or taxpayers from losses must end".

- The key element is to address systemic risk (banks and others too big and complex to allow to fail) with a single entity with responsibility over the major institutions.

- The need to establish and enforce substantially more conservative capital requirements for systemically important financial institutions.

- The requirement that leveraged private investment funds with assets under management over certain threshold register with the SEC.

- The need to establish a comprehension framework of oversight, protections and disclosure for the OTC derivatives market.

- To establish a stronger resolution mechanism to protect the financial system and the economy from the potential failure of large complex institutions (i.e. a wind up mechanism)

- The Volcker Report is similar but tougher with particular emphasis on systemically important financial institutions and restrictions on what they can do. Also, the national consolidated supervision of insurance companies needs to be established and Money Market Mutual Funds should be subject to bank supervision. At the same time, private funds need to be registered and the central bank should have strong role in financial stability issues.

- There are many other recommendations in the Report but generally follow the same lines as in Secretary Geitner's testimony.

c) <u>The Case of Insurance</u>

The Larosiere Report, more formally known is the "High-Level Group on Financial Supervision in the EU" makes special mention of insurance supervision.

Specifically the Report says:

"The crisis originated and developed in the banking sector. But the insurance sector has been far from immune. The largest insurance company in the world has had to be bailed out because of its entanglement with the entire financial sector, inter alia through credit swap activities. In addition, the failure of the business models of monoline insurers has created significant market and regulatory concern. It is therefore important, especially at a time where Europe is in the process of overhauling its regulatory framework for the entire insurance sector, to draw the lessons from the crisis in the US insurance sector. Insurance companies can in particular be subject to major market and concentration risks. Compared to banks, insurance companies tend to be more sensitive to stock market developments (and less to liquidity and credit risks, even if the crisis has shown that they are not immune to those risks either).

Solvency 2 is an important step forward in the effort to improve insurance regulation, to foster risk assessments and to rationalise the management of large firms, Solvency 2 should therefore be adopted urgently. The directive, especially if complemented by measures which draw the lessons from the crisis, would remedy the present fragmentation of the rules in the EU and allow for a more comprehensive, qualitative and economic management and supervision of large insurance groups. With colleges of supervisors all cross-border groups the directive would strengthen and organize better supervisory cooperation – something lacking up to now in spite of efforts made by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The AIG case in the US has illustrated in dramatic terms what happens when there is a lack of supervisory cooperation."

<u>What next? Reforming the International Monetary System</u>

- Reforming the way banks, investment banks and other financial institutions behave is critical to reduce the risk of another collapse of the system. But, it needs more which centres on the Group of 20 and the International Monetary

Fund to ensure that the system is more responsive to dangers and the IMF can help countries in temporary need of assistance.

- The G20 brings all the top countries into the system and especially the big development countries. Their role will expand in the coming years. Also, the G20 has given the Financial Stability Forum expanded membership and powers alongside a new title, namely the Financial Stability Board.

- Over the years the IMF has lost influence particularly among advanced countries. Emerging markets have quotas far short of their role in the world economy and feel that they are subject to different treatment than their bigger neighbors. They have now a voice in the G20 and the FSB but should have bigger influence in the IMF.

- Hence the role of many developing countries should be increased in the governance of the IMF. China, India, Brazil and Russia are good examples to have bigger quotas and Europe has far too many directors. Also, the top officials of the IMF should be selected based on merit and not just being from Europe and the US in the case of the World Bank.

- Most importantly, the IMF should act in a counter-cyclical manner being able to help countries through quotas credit lines and contingency funds on a substantial scale when there are failures in the international capital markets. This will boost confidence in the system just as financial market regulation and supervision is reducing bank and investment risks.

- Above all, as the world has changed with 50% of output coming from the developing world this needs to be reflected in the governance of the institutions responsible for world economic management. In addition, with the dollar accounting for 60% of world reserves but the US accounting for 20-25% of the world economy, this needs to change with the Chinese yuan playing a bigger role over the next decade.

<u>Conclusions:</u>

- 2009 will be the first year of much tighter supervision in all major industrial countries. The US will introduce legislation in the next several weeks, the EU is moving to implement the Larosiere Report and Lord Turner, Chairman of the FSA recently wrote a Report which is in the process of being implemented in the UK.

- While the Reports are very detailed, all want to see higher quantity and quality of capital for financial institutions. Leverage will be decreased and more emphasis is placed on liquidity levels.

- Also, everyone wants less pro-cyclically and more transparency whether in derivatives or elsewhere. The result will be that financial institutions will be subject to much more scrutiny and the old days of massive leverage in propriety trading levels and elsewhere is coming to an end.

- We will see a major battle in the United States about the institutional form of supervision with all the supervisory units like the FDIC, SEC etc fighting to preserve their roles. The chances are that the Office of Thrift Supervision will disappear and that some form of Board with the Chairman of the Federal Reserve, the OCC and the FDIC will be responsible for financial stability and not just the Federal Reserve which was the original preference of the US Treasury.

- Similarly, there is a move in the United Kingdom to give back supervisory powers to the Bank of England and disband or reduce the size and powers of the FSA. This is not likely to go very far but the Bank of England almost certainly will become responsible for financial stability.

- The Swiss National Bank has decided to adopt a “belt and braces” approach supplementing the tighter approach to banking with an old fashioned leverage ratio.

- Insurance is regarded as safer than banking but certainly not safe. Solvency II has been widely applauded in Europe and the emphasis on Pillar II capital has great support. Judgment and not simply a reliance on rules will be a central feature in the future of supervision.

- It is safe to argue that within a few years, banks and highly regulated institutions will be fighting for more freedom. But memories of the Great Recession of 2008-10 will last for many years so that finance will play a smaller role in the world economy than has been the case over the last two decades.

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June 8^{th} 2009

APPENDIX

IMF Projections for World Growth – April 22nd 2009
% Change

				Difference from Jan. 2009 Projections	
	2008	2009	2010	2009	2010
World output	**3.2**	**-1.3**	**1.9**	**-1.8**	**-1.1**
Advanced economies	0.9	-3.8	0.0	-1.8	-1.1
United States	1.1	-2.8	0.0	-1.2	-1.6
Euro area	0.9	-4.2	-0.4	-2.2	-0.6
Germany	1.3	-5.6	-1.0	-3.1	-1.1
France	0.7	-3.0	0.4	-1.1	-0.3
Japan	-0.6	-6.2	0.5	-3.6	-0.1
United Kingdom	-0.7	-4.1	-0.4	-1.3	-0.6
Canada	0.5	-2.5	1.2	-1.3	-0.4
Emerging and developing economies	6.1	1.6	4.0	-1.7	-1.0
Russia	5.6	-6.0	0.5	-5.3	-0.8
China	9.0	6.5	7.5	-0.2	-0.5
India	7.3	4.5	5.6	-0.6	-0.9
Middle East	5.9	2.5	3.5	-1.4	-1.2
World Trade	3.3	-11.0	0.6	-8.2	-2.6